THE UNEMPLOYMENT CRISIS AND POLICIES FOR ECONOMIC RECOVERY

HEARINGS

BEFORE THE

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THE UNEMPLOYMENT CRISIS AND POLICIES FOR ECONOMIC RECOVERY

FRIDAY, OCTOBER 15, 1982

Congress of the United States,
Joint Economic Committee,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, Hawkins, and Wylie.

Also present: James K. Galbraith, executive director; Louis C. Krauthoff II, assistant director; Charles H. Bradford, assistant director; Betty Maddox, assistant director for administration; and Mary E. Eccles, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative Reuss. Good morning.

The Joint Economic Committee will be in order for further hearings on its investigation in the Nation's unemployment crisis.

Recovery hasn't been sighted. We now have double-digit unemployment, which is producing new misery in sector after sector. Nothing resembling a recovery program is even in place. And the present President doesn't have a single constructive suggestion to offer.

A valid recovery program can be developed. It can be put in place in time to avert economic collapse. But we have got to act soon.

At the request of the Democratic leadership of the House and Senate, the Joint Economic Committee will be preparing policy recommendations for the lameduck session of Congress in November, with the hope that it can be a lameduck session that roars.

I would offer the following as the basis, in a preliminary way, for such a package:

INVESTMENT IN INFRASTRUTURE

The Nation's streets, bridges, water systems, ports, railroads, and other public facilities are in ruins. Jobs for some of our 11 million unemployed must be found building and maintaining these vital support systems.

HOUSING

Subsidies of moderately priced housing are essential as long as sky-high mortgage rates make home ownership for the great body of Americans unaffordable. In the process of meeting our housing needs, hundreds of thousands of idle workers in the construction industry would be brought back to jobs.

JOBS PROGRAMS

A well-run public employment program can quickly put people to work restoring public services at the State and local levels, and thus provide for a variety of unmet social needs.

MONETARY POLICY

Last week, the Federal Reserve happily abandoned its rigid adherence to monetary targets, in recognition of the critical need to take into account interest rates. This must not be a temporary correction, to be forgotten once the election is over. Monetary policy must be geared to the demands of a growing economy if recovery is to endure after the election.

In each of these areas, the committee will present concrete recommendations to a lameduck session.

We are happy to have this morning a most distinguished panel to assess the economy's prospects and alternative course of action. In a sense, they will provide the media—whom I am glad to see are here in force—with a Democratic answer to the President's television address the other evening.

Unfortunately, the television media were only able to cover the President's speech, which preempted the Brewers-St. Louis Cardinals World Series. The Milwaukee Brewers were so depressed by it that they proceeded to lose the game in St. Louis.

I am hopeful that today's testimony will so inspirit the Brewers that they will go out and take it from the Cardinals in Milwaukee tonight.

The group of statesmen—some elder, some younger—who are with us today include:

Robert Eisner, professor of economics at Northwestern University, adviser to Democrats for many years.

John Kenneth Galbraith, professor of economics emeritus at Harvard and also a counselor of Democrats for many years, starting in his successful efforts to grapple with the unemployment-inflation problem in F.D.R.'s administration.

This, I understand it, Ken, is your 74th birthday, and I join in wishing you all the best. May you have many more and continue to help this committee.

Walter Heller, professor of economics, University of Minnesota, who was Chairman of the Council of Economic Advisers under John Kennedy, the true founder of honest supply-side economics, which has fallen among thieves nowadays.

Ray Marshall, professor of economics and public affairs, University of Texas, and Labor Secretary of the Carter administration. He has been listened to some. Had he been listened to more, things might have been even better.

Willard Wirtz, chairman of the board of the National Institute for Work and Learning in Washington, Labor Secretary for President Kennedy and President Johnson, who has continued his expertness on the question of jobs and work in the years since.

We are honored and delighted to have all of you with us. And we look forward to the united learning that you will give us.

Representative Wylie.

OPENING STATEMENT OF REPRESENTATIVE WYLIE

Representative WYLIE. Thank you very much, Mr. Chairman.

I appreciate the opportunity for an opening statement and to welcome our distinguished witnesses to today's hearings.

I am interested in the advice you offer.

May I say, Mr. Chairman, I was rooting for the Brewers before this morning's session. I may have to reassess my position since testimony this morning might have some influence on the outcome of the World Series. On balance, I think I'll stick to the Brewers anyhow. [Laughter.]

I would like to begin my opening statement by suggesting a word of caution, if I may, to this distinguished panel. That sounds a little presumptuous on my part. But what one could do, it seems to me, as a policymaker in the early sixties, commencing from the base of almost no price inflation, cannot be done in the early eighties by an administration that inherited the inflation rate of double-digit proportions and the third highest level of unemployment since before World War II.

I think, personally, that we have much to be thankful for as a result of President's Reagan's economic policy.

The prime rate is 12 percent and falling. Under the policies of the previous administration, there was a prime of 21½ percent and talk of a prime of 25 percent or more at one time. The momentum has been broken, and the tide was decisively reversed by this administration, I submit.

In addition, inflation was eroding personal income at double-digit rates over the last 2 years of the previous administration. This administration has gotten inflation below 6 percent, and it's still falling.

Furthermore, by reducing the Federal income tax rates by 25 percent over 3 years, this administration has managed to restore a significant portion of the purchasing power lost to inflation during the previous administration.

To be sure, the Federal deficits are still too large in my judgment. Military spending is still increasing too rapidly, and unemployment is too great. These are substantial problems yet to be successfully resolved.

However, with interest rates much lower, and with the inflation rate virtually under control, it seems to me the stage is now set for an economic recovery.

With the recent surge in the stock market, stockholders are wealthier and can spend more. Just as importantly, corporations are well positioned to raise funds for inventories, for refinancing of high cost, short-term liabilities, and for capital spending for new plants and equipment.

In other words, I feel it is important, may I say, Mr. Chairman and distinguished panel, to stay the course and not abandon policies which require more than a year to produce their benefit.

Thank you very much, Mr. Chairman, for allowing me to offer that opening statement.

Representative REUSS. Thank you.

Representative WYLIE. Mr. Chairman, Senator Jepsen had an opening statement which he intended to offer. He's not here. And he's asked unanimous consent to have his comments in the record.

Representative REUSS. Without objection, Senator Jepsen's statement will be placed in the record at this point.

[The opening statement of Hon. Roger W. Jepsen follows:]

OPENING STATEMENT OF SENATOR JEPSEN, VICE CHAIRMAN

There is not a member of this Congress who is not aware of how severe unemployment is in this country. Too many Americans are facing the misery of waking up in the morning and not having a job to go to. Their families suffer along in this misery not only from a lack of money but also from the crushed spirit of the breadwinners.

Their plight is, in no small way, the responsibility of all the Members of Congress. Unfortunately, this autumn, the unemployed in this country are being used as political footballs. More unfortunately, some Members of this Congress fail to understand, or at least fail to mention, that unemployment has been a problem for many years.

It has been almost 14 years—1969, the first year of the Nixon administration—since we have had full employment in this country. It has been 10 years—1973, the first year of the Ford administration—since we have had unemployment below 5 percent. It has been three years since the yearly unemployment rate fell. Unemployment did not just arrive, it has been with us a long time. Of the 11 million people now unemployed, almost 8 million were unemployed in January 1981.

I think the President was correct this week when he said we all had to shoulder some of the blame for unemployment. Even some of the witnesses before us today, who were part of administrations that oversaw rising unemployment, must share some of the blame.

I do not think I would be far from wrong if I said that the witnesses before us represent one point of view concerning unemployment. Unfortunately, what we really need is a full discussion of the unemployment problem in order to determine the best solution. In fact, I am sure that this variety of opinions is what the esteemed speaker of the House of Representatives had in mind when he asked this committee to determine "the best, independent estimates" of the current unemployment problem and "the best and independent estimates" of the prospects for employment.

I value the opinions of the witnesses, I just wish that we could have had a fairer sampling of viewpoints to help solve our unemployment problem.

I think that the committee, the Congress, and the country would have been better served by a more judicial adherence to the request of the speaker of the House. In fact, such a straightforward and impartial hearing of opinions would have mostly benefited the unemployed—the people who are supposed to be helped by this hearing.

Representative REUSS. All right. We thank members of the panel for complying meticulously with our rule—if you call it that—for sending prepared statements in to us on time. We appreciate it.

Without objection, they will be received in full into the record.

We will now start out with Mr. Eisner.

STATEMENT OF ROBERT EISNER, WILLIAM R. KENAN PROFESSOR OF ECONOMICS, NORTHWESTERN UNIVERSITY, EVANSTON, ILL.

Mr. EISNER. Thank you, Mr. Chairman. I have a prepared statement which I will not read exactly.

I will start by asking how many remember the Humphrey-Hawkins Act set the target rate for unemployment for 1983 of 4 percent? Many—and too many economists—have had little dedication to an all-out drive to attain the rise to the full employment we enjoyed not much more than a decade ago.

The current economic situation is not the ordinary internally generated recession of a typical free-market business cycle. It is rather simply enough made in Washington. I have to say that there is a bipartisan responsibility for the economic mess, as the current administration calls it. Unfortunately, in the Carter administration there did begin an effort to try to slow inflation by causing a recession, a minirecession. I recall chiding a leading Carter administration economic policymaker at the time, asking "What is a nice guy like you doing trying to create a recession?" He replied, "Yeah, we're not even very good at it."

Fortunately, that was true, and perhaps because they were not dogmatic, that all-out, not quite willing to brook all of the disaster of the unemployment we've had, we never got unemployment very large in the previous administration. The current administration cannot escape responsibility for the increase from the 7.4 percent in the beginning of 1981 to the 10.1 percent, and rising, that we know of now.

It, indeed, was part of a very conscious policy of trying to slow inflation by causing slack in the economy. It related primarily to a much too tight monetary policy, to a misguided attempt to follow dogmas of a particular small group of economic theorists, indicating somehow if you kept monetary reserves growing at a very slow rate and at a steady rate, that would take care of things. Beyond that, the Government should keep out of matters. The Government, in effect, should be "off our backs," as it was put.

In addition, however, we have had a strange, internally inconsistent fiscal policy of varied tax cuts, particularly for the rich and upper middle income groups, and of a weird set of cuts in business taxes, so extreme, so distortionary that the administration went along with efforts, successfully, to water down and cancel out a good part of those, just in the last month or so.

We are told somehow that these policies are now preparing the way for recovery. I am reminded, painfully, as I am sure are so many of us, of the frequent statements by Herbert Hoover in the 1930's that prosperity was just around the corner. I call it whistling in the dark. In fact, I have no crystal ball, but neither do these people that claim to know that somehow we've prepared the way for a recovery. The economy can move up, it can move down.

What worries me, essentially, is that this administration has repudiated policy, as they are quick to point out, not just of Democrats but of administrations for 40 years, since we last had this record unemployment above 10.1 percent. We have largely had, in place, with more or less dedication, the notion that Government is responsible for preventing an economy from going out of kilter, for preventing a mass descent into tremendous unemployment and recession or depression.

Those policies have essentially, at least in word been abandoned, in the notion the Government has no role and it should be left to the free enterprise private economy. That, I think, suggests there are dangers in the current situation which go beyond what they have been before. I do not want to preach gloom and doom. I believe the American economy is essentially strong and resilient, but I have always had in mind the notion that there is a safety net in the broadest sense, a safety net for the economy as a whole, if there is a lack of purchasing power, if businesses were going broke, if people were sliding into unemployment at tremendous rates. I note that the latest figures for unemployment insurance claims, which are more recent than the 10.1-percent unemployment figure, are continuing at a very high, virtually record rate.

We have had the notion in the past, when these things occur, Government will step in to help. The answer we get at this point is, "No, we must stay the course. There is nothing for the Government to do but to follow the policies that have led us here and assume that they will remedy matters." I would suggest, however, a set of policies that I think will remedy matters. They are not the traditional quick fix. They are policies, in fact, that we have had, to a considerable part, if inadequately, over many years. I think there has been too quick a repudiation of policies in the past, under perhaps the pressure of well-financed extremist propaganda.

Everything we've done in the last 40 years has not been wrong. Somehow what we have done has prevented us from having 10.1 percent unemployment in the last 40 years.

One thing we have to do, I think most of us have agreed, is to quickly correct the disastrous monetary policy. I can't take much comfort from the recent fall in interest rates. Economists have told us for years that if you have a recession, if you have a depression, if businesses no longer have any stomach for investment or borrowing to expand, the demand for money will go down and interest rates will go down.

So that is, again, like the unemployment, exactly what we have created as part—associated with the unemployment and with the recession. We do need a firm dedication by the Federal Reserve, with whatever prodding is necessary from the administration and from the Congress, to set the broad outlines. We need a policy which is dedicated to getting the economy back to prosperity, which means easing the money supply, getting real interest rates down.

I might point out again, that glad as we are to see lower and nominal interest rates, people are not going to spend, they're not going to buy in the face of even moderately lower nominal rates, with inflation and expected inflation way down. We have people buying houses at 10, 12, 13 percent interest rates, as long as they expected housing prices to continue to rise at 10, 12, and 13 percent. Even if mortgage rates now get down to 12 percent, we will have, I would predict, a pitifully small housing boom. as long as people are worried about losing their jobs, and as long as that 12 percent cannot be sustained by high expected inflation.

Beyond the monetary policy, the reduction in real interest rates, as the chairman suggested, there is a need for a tremendous increase in public investment. We frequently talk about the need for investment as a means for bringing about growth. I have been on record criticizing the accelerated cost recovery system, now amended, as distortionary and ineffective, but there is great room for investment in bridges, in roads, in water systems, in all that Government can provide and must provide, which will then facilitate private investment and general growth.

Most important, there must be Government investment in human capital, in that which is the bulk of investment, the basis for both product and growth, and that means investment in training, investment in supplementing and subsidizing, in giving incentives to private firms to hire. I have elsewhere documented and gone into detail on what I think would be a remarkably good use of either general funds or tax money to offer businesses the incentive to hire youth, to hire minorities, to hire women, and generally to hire from the unemployment rolls. That in itself, in my opinion, would be insufficient. There is also a great need for direct Government efforts to train those who are untrained, to retrain those who are no longer in positions, who no longer have jobs for which their training fits.

I might just refer briefly to the notion expressed by Treasury Secretary Donald Regan that the normal rate of unemployment in this country is now 6.5 percent. I would not accept that. I think those economists who have trumpeted that figure are being misused, and I hope they would recognize it. There is nothing magic about a 6.5-percent unemployment rate, which we cannot even get. I don't believe that we can argue, because we have more blacks, more women, more youth in the labor force, that they are somehow doomed to being unemployed, and that, therefore, the base percentage rate of unemployment must be lower. There is a limit to what we can accomplish in reducing unemployment by broad-based measures of stimulating demand, and to go beyond that, we do need a massive program of matching jobseekers to openings and a program of subsidization of centers of training and retraining to get the unemployment rate down to where it could be, where it has been. I can remind all of us that no more than 13 years ago, in 1969, we had an unemployment rate below 3 percent. And I fail to see where the economy has changed to the point where now we should say 6.5 percent is our target and then accept 10.1 percent.

I might close quickly by facing frontally the notion that this is more "spend, spend, and spend." The question of whether the Government should spend is a question of what it should spend for and whether it is worth it. We can spend trillions, literally, in accelerating a hopeless arms race. There is much more profit to the American economy, to the security of the American people in seeing to it that we get our people back to work.

[The prepared statement of Mr. Eisner follows:]

PREPARED STATEMENT OF ROBERT EISNER*

How many remember that under the Humphrey-Hawkins Act the target rate of unemployment for 1983 is 4 percent? Our failure to refer to that goal, let alone implement programs to achieve it, suggests that the current economic disaster is a national disgrace.

It is of course clear that many in our body politic -- and too many economists -- have had little dedication to an all-out drive to attain the relativelly full employment we enjoyed not much more than a decade ago. What is disturbing is the hypocrisy with which some have proceeded with anti-employment policies -- in the presumed interest of reducing inflation.

For make no mistake about it, the current economic situation is not the ordinary, internally generated recession of a typical, free market business cycle. It is rather, clearly and simply, made in Washington.

Unfortunately, there is something of a bipartisan responsibility for the "economic mess" as current Administration spokesmen like to term it. Following upon new supply shocks from increases in petroleum prices and of other raw materials on world markets, and certain self-inflicted supply shocks, inflation did rise again in the last years of the Carter Administration. As public concern grew, the Carter Administration initiated the policy of trying to "slow down" the economy -- a thinly disguised euphemism for creating a mini-recession -- in order to reduce the rate of inflation.

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*William R. Kenan Professor of Economics, Northwestern University.

To the minds of a number of us who knew better, this was indeed a misguided policy. There is every evidence that only sharp and sustained recession can do much to end inflation, particularly an inflation fueled by higher supply prices rather than excess demand.

I recall that when I chided a leading Carter Administration economic policymaker at the time, asking "What is a nice guy like you doing trying to create a recession?", he replied,"Yeah, and we're not even very good at it."

That last was fortunately true. The current Administration cannot escape responsibility for the fact that it inherited an unemployment rate of 7.4 percent, a rate that I and Humphrey-Hawkins deemed much too high but too many others were willing to accept in the name of combatting inflation, and by now has given us the horrendous 10.1 percent figure reported last week. The difference, I fear, relates to the dogmatism, indeed fanaticism, with which the current Administration has pursued at best untested and at worst blatantly fallacious economic theories.

In the name of fighting inflation, the Administration has encouraged and supported a monetary policy which has so held down on monetary reserves, in an effort to hold down particular measures of the money supply, as to bring about unbearably high real interest rates. This has brought near-collapse of the housing markets and body blows to the production of many consumer durables, greatly compounding in particular the problems of our hard-pressed automobile industry. It has helped curb business investment, supposedly most favored by Reaganomics, and has contributed mightly to our record numbers of business bankruptcies.

Our fiscal policy, instead of focusing on broad-based support of aggregate demand and economic growth, became the captive of so-called "supply-side economics," which was soon acknowledged in very high Administration circles, as we recall, to be merely a new version of the old trickle-down economics that does indeed go back, at least, to Calvin Coolidge.

We thus have had a weird mixture of very large tax cuts for the rich, net tax increases for the poor as payroll taxes and inflation continued to take their disproportionate bites, large cuts in government programs designed particularly to help the poor and those in need of employment, huge cuts in business taxes, so extreme and distortionary that they have now wisely been partially reversed, and very large increases in commitments for military expenditures and future tax cuts which have helped frighten those in financial markets worried about the huge, contemplated budget deficits.

I need not dwell on details of the current economic situation, which members of this Committee must know well. The double-digit unemployment figure, unlike our frightening double-digit inflation as measured by the Consumer Price Index in the recent past, is in no part a statistical mirage. If we add 1.7 million of "discouraged workers" who have given up looking for jobs, and half of the millions who are part-time for economic reasons, we reach a relevant figure of some 14 percent without employment. This figure is so high that it has directly affected millions of middle- and upper-middle class people for whom unemployment is generally something one hears about on television. But unemployment remains unevenly distributed and has struck particularly cruel and bitter blows in major industrial areas, such as in my own state of Illinois, along with much of the Midwest, and among blacks and other minorities, youth and women. And it has been devastating to millions of workers in our major goods-producing industries -- construction, automobiles, steel and other primary metals, textiles, and lumber and wood products.

I have no crystal ball for the future. But those whistlers in the dark, evoking memories of Herbert Hoover and the Great Depression with their unabashed proclamations that "prosperity is around the corner," have no crystal ball either. Concensus forecasts have suggested that we may be "bottoming out," but with such a slow recovery in sight that unemployment will hardly decline and may yet grow.

But it is important not to claim certainty or clairvoyance in any forecasts of the future. We must all recognize the range of possibilities and reasonable probabilities of future events, and hence the serious potential current dangers. The economy may be bottoming out and a slow and inadequate recovery may be near. But it is also possible that the dismal developments we have seen already, along with any new shocks to the system, may generate serious further deterioration and collapse.

I have not usually been a preacher of gloom and doom. I have long seen the American economy as essentially strong and resilient and indeed able to survive a remarkable amount of misdirection from Washington. My generally sanguine views, however, have related to a broad complex of economic policies which have been followed in the United States and indeed virtually all of the Western world for almost half a century. These have been supported by a recognition, by most Democrats and Republicans alike -- and by Laborites, Social Democrats, Christian Democrats, Liberals and Conservatives alike in the rest of the world -- that however much we are dedicated to "free markets," government does accept a responsibility to prevent major recessions and to combat major unemployment. The Reagan Administration, like the Thatcher Administration in Great Britain, has repudiated this general concensus. It denounces fifty years of Republican and Democratic administrations for putting "big government" on our backs. In the name of freeing us from that burden, it has proceeded to reduce and dismantle program after program to maintain our economic well-being. Its ideological motivation is clear. We are all better off, this Administration believes, if we operate in this mythical "free market" without government help, except insofar as this is provided by sharp increases in military expenditures. It is apparently inspired by a small number of articulate "new economists" who believe that whatever level of employment or unemployment the economy attains is somehow "equilibrium," and that government intervention to reduce unemployment can have no long-run benefits.

My usual optimism is hence sharply tempered. Recession phases of business cycles do tend to end and be followed by recoveries. Recessions in recent decades have come to an end particularly with the help of broadly countercyclical government fiscal and monetary policies. If those policies are eschewed and we are told to "stay the course" in the hope of ultimate salvation, my worries increase sharply. There is nothing, after all, immutable about economic systems and economies. Like human beings, they occasionally get sick, and usually recover. But if we persist in policies to lay us low in order to avoid the danger of "overheating," all bets may be off. Human beings, after all, usually recover from many illnesses, but not the last. An Administration policy that stubbornly precludes prescriptions for recovery may hasten the final collapse.

In proposing a set of policies to move us off the current course, we may certainly be alert to new ideas, but we must not be intimidated by well-financed extremist propaganda from reviving old policies that have worked in the past. The fact is that until this Administration, with over forty years of commitment, however imperfect, to broadly countercyclical government policies, we never did have double-digit unemployment. A return to some of the policies engendered by that commitment might help. Improvements and additions would help all the more.

First, monetary policies of the last few years must be reversed. Attempts at rigid adherence to monetary targets designed to restrain the economy must be abandoned. If the Federal Reserve does not change course on its own, the Administration or the Congress must force it to do so.

Falls in interest rates that we have just witnessed, however welcome in themselves, seem more to be the result of the recession itself and the consequent reduction in effective demand for money than a significant easing in the money supply. We might perhaps be grateful to the Fed for avoiding further tightening of money at this time. But accommodating only the reduced demand of a sick economy does not in itself offer promise of a healthy recovery.

I am not suggesting that Congress take upon itself the technical details of administration of our monetary system. But Congress does set the broad outlines of economic policy and must indeed accept some responsibility for past Federal Reserve actions by encouraging it to set and present targets for monetary aggregates. As is all the more clear with our changing monetary institutions and the necessity of successive changes in our definitions of money, the Federal Reserve should abandon its restrictive monetary targets. There is already some hint that, faced with surges in checkable desposits stemming from monetary innovations and deregulation, the Federal Reserve is already doing that. More fundamentally, the Fed should return to setting monetary policy in terms of the needs of the economy. At this time, those needs dictate a reduction in real interest rates. Whatever the conundrum of long term equilibrium theory, it is clear that increasing monetary reserves now can bring about significant reductions in these critical rates.

It is important to recognize that it is real interest rates that must come down. There is little or no advantage to the economy as a whole from reductions in nominal interest rates that merely accompany reductions in actual and expected inflation. In particular, our now devastated housing industry was previously sustained by high rates of expected inflation, despite high nominal interest rates. One could find it advantageous to pay 10 percent and 12 percent mortgage rates to buy houses which were expected to appreciate by 10 percent or 12 percent or 15 percent per year. It does not pay, however, to buy houses with 16 percent mortgages and 5 percent inflation. And it must be noted that most people will be unable or unwilling to buy houses at 12 percent mortgage rates with expected inflation of only 5 percent. Real interest rates, the differences between the nominal rates and the expected rates of inflation, must come down if the housing industry is to revive.

Reductions in real interest rates will also prove a major stimulus to the automobile industry, to purchases of consumer durables generally, and, particularly as the economy recovers, to business investment in plant and equipment.

With regard to this last, I may note parenthetically but significantly that the costly accelerated cost recovery system (ACRS) of the Economic Recovery Tax Act of 1981 reduced the cost of capital by some two percentage points according to calculations undertaken with the Treasury's Office of Tax Analysis Tax Depreciation Model. Increases in real interest rates since enactment of the ACRS business tax cuts have raised the cost of capital by considerably more than ACRS would have reduced it. Whatever the merits of the accelerated cost recovery system, and I have argued that they were few indeed, the accompanying monetary policy more than negated them.

Return to a sane monetary policy would be an important contribution to economic recovery but there are many more measures that can and should be undertaken. First, we should undertake major government programs to utilize idle capacity of people and machines for a great program of public investment. In housing itself, beyond the stimulus from a corrected monetary policy, there is much room for direct government encouragement. By the appropriate standards of today, we may well be back in the situation of one-third of a nation ill-housed to which Franklin D. Roosevelt addressed himself half a century ago. There is no excuse for vast unmet housing needs while hundreds of thousands of construction workers are idle. We have indeed had disappointing and miserable experiences with subsidized low-rent housing for the poor. Might not all of us who see the advantages of private property support instead new subsidies for home ownership for the poor?

Tax subsidies relating to the taxation and deductibility of interest, as is well known, already offer major advantages to higher tax bracket, middle and upper-income Americans. Similar subsidies to low-income Americans would make possible vast increases in owner-occupied housing, with all of the advantages they entail for preservation of basic living standards and neighborhood values for all of those concerned.

In addition to housing, there are vast needs in the form of public investment in basic transportation and other social overhead capital. How many times must we be reminded that thousands of bridges are becoming too dangerous to travel? How much more must we allow our road system to crumble before we undertake the massive investment necessary for its renovation and expansion? How much further must we allow our essential resources of land, water and air to deteriorate out of short-sighted and misguided public frugality? Failure to act in these areas would be stupid even if we had to divert resources from other productive activity to meet these needs. To allow our public capital to deteriorate further when there are millions of idle workers and thousands of companies with under-utilized capital ready to go to work is utter folly.

Easier money and public investment will prove significant measures to move us away from the depths of our current recession. Much more, however, is in order to achieve stated, if ignored Humphrey-Hawkins goals of full employment, as appropriately defined for 1983 at 4 percent. Treasury Secretary Donald T. Regan has been quoted as arguing that the norm for "full employment" has now become about 6.5 percent. Some of my colleagues in the economics profession have indeed been free with arguments that changes in the composition of the labor force in the direction of more women, youths and blacks have raised the original full employment rate of unemployment from 4 percent -- or, it might be noted, the 2.9 percent attained as recently as 1969. It is of course true that unemployment tends to be more concentrated among "marginal" members of the labor force. I presume that a century ago these were largely new immigrants from abroad. But I see nothing unique about blacks or women or youth that should lead us to doom them to perpetually high rates of unemployment and to assume that when their proportions in the labor force rise it is inevitable that average unemployment will rise.

A correct inference about the presumed 6.5 percent figure, from which we are currently so far, is that, with existing labor markets and government policies, broad and generalized macroeconomic programs for stimulating demand bring inflationary pressures as unemployment is reduced below it. But whatever our view of the tradeoff between unemployment and inflation, there is no reason to accept the figure of 6.5 percent as the immutable "non-accelerating inflation rate of unemployment," as it has been called. Simply enough, there is a substantial panoply of programs which can and should be introduced to get at significant components of this 6.5 percent, if indeed it is that large.

For one thing, rather obviously, labor markets should be improved. The vast expansion of computing facilities we are witnessing certainly has other uses than keeping track of inventories and accounts receivable. We should provide a nationwide listing of job openings and qualified job seekers, and significantly reduce their coexistence.

But reaching further, we could insure that job workers be qualified. We have squandered many tax dollars on subsidization of business investment in plant and equipment, something that I long argued should better be left to private decision-making in competitive markets. But adequate investment in human capital is something that we cannot expect from free markets.

If only because we are, fortunately, not a slave economy, it does not pay business firms to invest adequately in the ability, training and general human capital of workers because they cannot reap all of the benefits of such an investment. Yet similarly, because human beings cannot offer themselves as collateral, workers cannot borrow enough, even if they could afford to take the risk, to invest adequately in themselves. We are thus faced with millions of potential workers, particularly youth, who lack jobs because they do not appear productive to potential employers. Yet we know that with proper training and experience they would appear productive and employable. The problem is particularly acute among blacks and other minority youth who never get a chance to acquire the human capital enjoyed by more prosperous members of society. It is also acute among millions of experienced workers laid off in declining industries, where retraining for other work may prove essential.

This is clearly a situation which calls for a combination of direct government expenditure for education, training and employment with incentives to private firms to provide the job training and experience which will produce not only goods and services which are profitable for the firm but productive participants in the economy as a whole for years to come.

I have for a number of years advocated a variety of tax incentives for private employment. I shall not here spell them out again in detail but may mention that they would encompass substantial tax credits or direct subsidies for employment of youth, of women and veterans rejoining the labor force and for all those who have been unemployed for more than a minimal period of, say, 13 weeks. Such credits or subsidies need come to no more than the amounts we pay for unemployment benefits, and would be far more beneficial.

While tax incentives and direct subsidies for employment of the unemployed and among major groups subject to high or structural unemployment would move us a very substantial way toward appropriately defined levels of full employment, we should allow no ideological prejudice to prevent the development and extension of comparable programs by government. There may well be many potential workers whom private employers would not hire even with 100 percent subsidies. Their apparent lack of suitability and the risks attached to their employment, along with the administrative costs of hiring and firing may be such that no conceivable tax incentive or subsidy would work under current conditions. It would then be in the interest of society for government to undertake programs involving training, motivation and preparation for employment. The armed forces, in war and in peace, have traditionally found places for many facing rejection by private industry. Is it too much to ask for peace-time, civilian programs to tap countless unutilized human resources which, once developed, will become private and public assets?

To all of these proposals, I can anticipate the retort that this is more of "Spend, spend and spend!" Will such spending not either force increases in taxes which will hurt the economy or increase budget deficits which will also be injurious? I should not close, therefore, without meeting these issues head on. First, of course, one cannot avoid questioning the consistency, if not the judgment of those who would spend trillions of dollars in the acceleration of a hopeless arms race but cannot find the funds to invest in our own people. Second, if increased taxes were necessary, just as with any other cost we impose upon ourselves as individuals or collectively, the question to be answered is simply whether the benefits are likely to exceed the cost. The benefits of getting people out of idleness and into work, now and for the future, are clearly so great that it is hard to imagine any objective calculus would indicate that it would not be worth the cost.

But unpolitic as it may appear, I cannot refrain, as an economist, from challenging some of the current myths and near-hysteria about budget deficits. The bottom line, of course, is not the government account, unless we have a perverse, statist or totalitarian mind, but the account for the product of the economy as a whole. If budget deficits contribute to higher real national income and product, they are good. If they somehow contribute to lower real product by creating chaotic inflation, they are bad.

It is absurd to believe that the current, largely recession-created budget deficit is creating inflation. The deficit has swelled because of lack of adequate spending, output, income and employment. To try to reduce the deficit now either by reducing government spending or raising taxes will only aggravate the recession.

Over the longer run, it is true, projected increases in government expenditures, particularly for the military, and already legislated cuts in future tax rates do lead to projections of uncomfortably large deficits. Even here, considerable confusion is engendered by conventional government accounting. By government accounting, with no separate capital accounts, every major private firm would be showing huge deficits. Conversely, if government were to adopt private accounting methods, particularly excluding capital expenditures from current accounts, government budgets would prove well in balance.

But further, inflation has bedeviled all conventional accounting, private and public. Most of us are fond of pointing out some of the inconsistencies and distortions introduced into private accounting. We usually fail, however, to note that high rates of inflation similarly distort government accounting. Most particularly, as a result of high inflation and expected rates of inflation, the government pays huge amounts, based on high nominal rates, in interest charges on the federal debt. Those high nominal interest rates are, as we all know, necessary to compensate holders of public debt, or any debt, for the year-by-year depreciation in the real value of such debt brought on by inflation. What this means, however, is that while high government interest payments, swelling the measured budget deficit, are going largely to compensate private holders for the inflation-related losses in the real value of their government securities, the government is in turn itself gaining from the year-by-year reduction in the real value of its outstanding debt. The real measure of the government deficit would then be the net increase in the real value of government debt, or the difference between the nominal deficit, adding to the debt, and the reductions in the real value of debt resulting from inflation (and, in addition, reductions in market value of outstanding debt due to increases in interest rates). An analogous way of correcting measures of the budget deficit (or surplus) is to count in expenditures only the payments which would correspond to the real rather than nominal interest rate.

I do not mean to insist that we get involved in these seemingly abstruse matters of measurements of budget deficits, although I am pleased to note that the 1982 Economic Report did use some tables which I prepared in developing some of these issues. It is important, however, that we do not allow outdated myths and measures relating to government budgets and fiscal policy to prevent us from doing what we have to do. And what we have to do is to bring our economy back to health, and along with it the economies of most of the rest of the world, by putting our people back to work.

Representative REUSS. Thank you, Mr. Eisner.
Mr. Galbraith.

STATEMENT OF JOHN KENNETH GALBRAITH, PROFESSOR OF ECONOMICS EMERITUS, HARVARD UNIVERSITY, CAMBRIDGE, MASS.

Mr. GALBRAITH. Mr. Chairman, the unemployment figures have received greatly deserved attention these last few days. They, indeed, reflect a massive despair, deprivation, and waste of manpower and opportunity. But they are also a symbol of a much more extensive anxiety, waste, and danger. They are the companion piece of low levels of plant utilization, record levels of small business failures and personal bankruptcies, the threatened insolvency of savings institutions, some commercial banks and some of our larger corporations, and of grave economic stress among farmers.

And through its effect on international trade and international capital flows, our economic performance or nonperformance is now a threat to the international financial system and the economic and political stability of our more vulnerable neighbors and trading partners.

The cause of this disaster, as it must now be called, does not lie in some deeper past. The archeological alibi which now ascribes all blame to earlier policies of Democratic—and Republican—Presidents is transparent escapism; everyone knows that were things going well, all credit would be taken for the policies presently in effect. Responsibility must always lie firmly with those of whatever party or persuasion who are currently in power.

Economic performance, Mr. Chairman, does not lie suspended in space between the errors of the distant past and the promise of the indefinite future.

We have had a period of unprecedented experiment in economic policy. It has failed. The present need is to accept the fact of failure—a fact that is for all to see and for millions of our fellow citizens to feel—and to launch on a better and wiser and, in a very real sense, more judiciously conservative course.

EQUITABLE DISTRIBUTION OF INCOME IS SOUND ECONOMIC POLICY

The failure arises from two causes. All recent policy has had the unifying theme of shifting income and spending power to the affluent from people of middle income and below. That was the effect of the tax reductions, of the accompanying cut in social expenditures and of the increase in military spending. The rich have the agreeable alternative to not spending their income; in economic terms, their marginal propensity to spend is low. This is also the position of those in major line of benefit from the increased military expenditure. People of middle income and below do not have the luxury of choice as between spending and not spending; their marginal propensity to spend or consume is high, a function of pressing need. We have shifted income from those whose spending and demand are assured to those whose spending and demand are discretionary.

In the past, the case for a more equitable distribution of income and for public help to the disadvantaged has been made on broadly compassionate grounds. The lesson of current economic policy is that such compassion and fairness have a strongly functional aspect. They guide income to the people who can be counted on to make economically effective use of it. An equitable distribution of income is, with all else, a sound economic policy.

With the regressive movements in social welfare expenditures and in taxation has gone the great experiment in monetarism, an experiment which, as Professor Eisner has said, antedates the present administration. This experiment, compensating in part for the tax reduction, the increased military spending, and the present and prospective deficit, has operated through high interest rates to restrict spending and respending from borrowed funds. That is how monetary policy works against inflation.

In a modern, highly organized economy—one of large corporations, effective unions, substantial public employment—the first effect, as we now know, is a cutback in business investment, in current use of plant capacity—and notably in employment. Only as there is a substantial excess in plant capacity do producers restrain prices, only as there is substantial unemployment do unions forego wage increases.

Monetary policy, in other words, works against inflation only as it produces a substantial recession—or depression. This is not a matter of introspective theory; it is the recent and present experience, available for all to see. The unemployment we presently experience is the direct result of present policy. Monetary policy works against inflation by way of a particularly brutal form of prices and incomes policy, one that brings its pressure to bear by way of idle plant capacity, business insolvencies, and mass unemployment. I am not being parochial or partisan on these matters. As you know, that is never my tendency. What I say is common ground for economists.

The outgoing chairman of President Reagan's Council of Economic Advisers, Mr. Weidenbaum, attacked the damaging commitment to the military budget and, by inference, the greater resulting reliance on monetary policy. His successor is even more stern on the supply-side aberration and on monetary policy. No one has put the matter more bluntly than Mr. Feldstein:

> The extremists among both the supply-siders and the rational-expectations monetarists who predicted that inflation would be reduced without raising unemployment have been decisively proven wrong.

If Mr. Feldstein were here this morning, he would not encounter, in this panel, any serious objection to that very straightforward comment.

ANTIRECESSION PROGRAM PROPOSED

However, it is not enough to cite the errors of the recent past; there must now be an affirmative program to repair the damage, get people back to work and to insure against a serious breakup of the international system. The agenda is not at all obscure or even dramatic; most of it is the self-evident response to recent history. It involves the following steps:

First, an arrest and reversal of the shift in public expenditure from civilian to military expenditure. On this matter, we have been responding not to need but to the military and weapons industry power and to their captive Secretary of Defense. There is now a highly significant shift of public, business, and political opinion against the open military checkbook. The Congress and the administration must now take notice. The effect of sanity on the military budget will be a stronger fiscal policy, a reduced pressure on monetary policy, lower interest rates, and better economic performance.

Second, we must cancel the reduction in the personal income tax scheduled for next midyear. Its effect on individuals at lower- and middle-income levels is either nonexistent or invisible. As I have noted, its effect on the spending of the rich is inefficient. The revenue is needed for job efficient programs and to relieve the pressure on monetary policy.

Third, in response to the reduced military spending and the abandonment of the further tax cuts, we should have a continued easing of Federal Reserve policy. It is a far, far better thing to have fair taxes than murderous interest rates. We have paid heavily in these last years for a loose fiscal policy and a tight money policy when, in fact, the reverse is required.

Like others, I have taken note of the response in these last days of the financial markets to the relaxation of monetary policy. It is something, one hopes, that will last beyond the election and will be part of a much more general reform. And I, here, endorse the comments of Professor Eisner and of the chairman in this regard.

Fourth, there must be no further cuts in the social programs. Instead, we should restore programs on a selective basis where cuts have caused particular hardship. I have especially in mind aid to families with dependent children, the food stamps and—as an efficient short-term expenditure and an important long-term investment—the support to student loans and education. The recently enacted job-training legislation is a useful step. Let it be noted, however, that job training is not a substitute for jobs.

Fifth, we must have a serious attack on structural unemployment by direct employment programs in conjunction with the States and cities. Within these last years, as the chairman earlier said, we have become aware of the sorry and, in many cases, devastated conditions of our public capital plant. It is outrageous that this deterioration should continue when there is so much manpower available to put it in repair. I have in mind action along the lines of House Joint Resolution 562. This was widely dismissed as a preelection political gesture. When the election is over, the Congress should return to it as a timely and much needed action.

Sixth, somewhat reluctantly, I have come to the conclusion that we had better have in place a financial institution of last resort for lending and for other socially urgent investment along the lines advocated by Felix Rohatyn. We face the possibility of insolvencies in the banking and industrial structure that could have a cumulative effect. And we now experience a financial astringency that is inhibiting much-needed capital investment. Thus the need.

The Reconstruction Finance Corp., the model for such action, was not, conservatives should be reminded, a New Deal innovation. It came into existence under the impeccable Republican auspices of Herbert Hoover. The first head was Charles G. Dawes, a former

Republican Vice President who served in the post until the day when his own Chicago bank, imminently threatened by insolvency, needed a rescuing loan itself, and he had to resign and catch the train to Illinois to become a borrower himself.

Finally, we must assume that, as and when employment recovers and economic growth resumes, inflation will recur. There is now in circulation, recently iterated by Chairman Paul Volcker, the peristalsis theory of inflation. It holds, by biological analogy, that inflation, once extruded from the system, will be gone for good.

This, not to put too fine an edge on things, is prime nonsense. The basic causes of inflation, particularly the interaction of the wage and price structure, remain as before. With recovery, we will have inflation as before—perhaps, if past trends persist, at a higher rate. We must be prepared to deal with it by more effective and more humane methods than in the past, specifically by measures other than an incomes policy enforced by idle men, idle plant, and general recession.

The Government, the unions, and the larger corporations must, instead, seek a social consensus stabilizing prices and incomes, and enforced as necessary by law. This is the only possible substitute for price stability induced, as under present policies, by massive hardship and despair.

Persistent in the belief of the present administration is the notion that economic recovery and improving employment are an autonomous tendency of the system. Suffering is the natural prelude to rejoicing. We have been pampering the poor and depriving the affluent for a long time; once the first are sufficiently punished and the second sufficiently rewarded, the economy is bound to respond.

Here we have the basis for the biweekly forecasts of Secretary Regan that recovery is just ahead, just beginning, just around the corner.

There is, Mr. Chairman, no such autonomous tendency. Recovery is not the work of kindly gods with a special commitment to the free enterprise system: it is, alas, the affirmative accomplishment of man—and woman.

Representative REUSS. Thank you, Mr. Galbraith.

Mr. Heller.

STATEMENT OF WALTER W. HELLER, REGENTS' PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA, MINNEAPOLIS

Mr. HELLER. Mr. Chairman, I was asked to look at the general economic outlook, the general economic environment of the unemployment problem, but I hope I will be pardoned if I occassionally venture into areas of policy and political economy. I have submitted earlier to the committee the bank letter that George Perry and I got out a couple of days ago, "U.S. Economic Policy and Outlook," and I would like to present a brief summary of that with some additional comments.

Under Reaganomics, we have traded double-digit inflation for double-digit unemployment. And with the current bleak prospects for the economy, the sad prospect is that unemployment will hover in and around the double-digits for months to come. The best hope for putting and keeping the economy on the recovery track is a Federal

Reserve policy that decisively breaks out of the monetarist tight-money trap coupled with a fiscal policy that puts us on the path to balanced budgets at high employment without slamming on the brakes just when the economy gets moving again.

The U.S. economy has been on hold for 3½ years. Output is no higher today than it was in early 1979, a sputtering performance that has added over 5 million workers to the ranks of the unemployed and pushed factory operating rates down to their postwar low of 69 percent of capacity.

Although I had expected a muted recovery to begin this quarter, a careful sector-by-sector appraisal of prospects that George Perry of Brooking and I have just completed simply doesn't reveal enough strength anywhere to get an economic revival underway this year. Reaganomics with its combination of a fast and loose fiscal policy and a tightly monetarist Federal Reserve policy, has kept real interest rates sky high throughout this year's severe recession. There is much talk about how interest rates have come tumbling down but so has inflation, so that real interest rates are still extremely high. The high cost of money has thus far overwhelmed the stimulus of tax cuts, defense boosts, and lower inflation. One hopes, but has no assurance, that last week's turn in Federal Reserve policy is not just a 1-month wonder but will persist until recovery is solidly underway.

By rights, we should be in a cyclical recovery. Consumers have enjoyed a sizable tax cut, defense spending is on the move, inventories have been cut, inflation is down, interest rates have softened, and the upsweep in stock and bond prices has added $300 billion to people's assets. I note, by the way, that some economists seem to think that the latter will substantially stimulate consumption, and I understand that the orders for Mercedes and Gucci have increased tremendously.

But these economic pluses have been no match for the continued sources of weakness. Consumers are cowed by double-digit unemployment and growing layoffs. Manufacturers and distributors are still cutting inventories. State-local governments are retrenching. High mortgage costs continue to burden housing. Auto production schedules for the current quarter have been cut significantly. Business capital spending is reeling under the impact of weak markets and low-capacity utilization. And the combination of our strong dollar and weak economies abroad is sharply cutting net exports.

Barring unforeseen strength in consumer purchases or a sharp turn in Federal Reserve policy, we now expect recovery to be delayed until well into 1983. This will keep the official unemployment rate above 10 percent for months to come and will bring the comprehensive unemployment rate, embracing both part-time and discouraged workers, as well as full-time workers, to 14 percent or more. It is there now. I retch at some of the statements that come from the White House. "Yes, 10 percent of the people are unemployed, but 90 percent are employed." Even the basic statistics totally ignore a lot of people that have been knocked out of full-time employment into part-time employment or knocked out of the market altogether. Since this is the political season, when President Reagan asks us to hold him harmless in the blame game on unemployment, I note that Margaret Thatcher, in a catch sentence that echoes Mr. Reagan's statements, tries to take the political sting out of 14 percent unemployment in Britain by saying, "Today's unemployed are the victims of yesterday's mistakes."

Well, in this country, yesterday's biggest mistake was the coupling of a record peacetime buildup of the military with a record peacetime tax cut, thus generating alltime record deficits and a chokingly tight Federal Reserve policy.

This grim job outlook will be paralleled by further declines in output, operating rates and profits. Average operating rates in manufacturing will drop to only two-thirds of capacity. Profits will suffer further declines in the first part of 1983.

TRADEOFF BETWEEN UNEMPLOYMENT AND INFLATION STILL EXISTS

The miserable state of the economy has its counterpart in a brighter outlook for inflation. The tradeoff between unemployment and inflation still lives. Economic policies that have generated what will soon be 4 years of no growth—nothing like it has been since the Great Depression of the 1930's—have also ground down the rate of inflation. No wonder. Even if we assume that our capacity to produce, our GNP potential, has been growing at only a bit over 2 percent per year—and many would put it at 2½ percent to 3 percent—actual output is running between $250 and $300 billion a year below our potential. This huge overhang of excess labor and plant capacity—together with the competitive pressure of falling import prices—has forced moderation in both wage and price behavior.

Add to this the impact of large crops on food prices, the impact of worldwide economic weakness on energy prices, the impact of deregulation on transportation prices and wages, and the impact of Federal Reserve policy on housing prices and now on mortgage rates—may I note, I don't find any of those major forces attributable to the one who is claiming credit for them—and it is not surprising that the overall picture is one of continued quiet on the inflation front.

What about monetary policy? The Federal Reserve's monetarist strategy, as has already been emphasized by our fellow members on this panel, for the past 3 years has kept real interest rates extraordinarily high at every stage of the cycle. This has not only pushed us into the present recession but could well prolong it. What we need now is more than just the letup in monetary stringency that comes naturally from a listless and financially fragile economy. We need an active pursuit of lower rates before things get worse.

True, we have had a welcome drop in rates since midyear, but the long-term rates, and particularly the mortgage rates, have softened very little.

The sense of relief these lower rates bring is offset by the apprehension that they are too little and too late to avoid a further softening of the economy. By any test of past experience, monetary policy is still far too restrictive for this stage of the business cycle. A simple comparison of real interest rates—market rates minus the inflation rates—drives this home:

In the early years of previous post-war recoveries, real interest rates averaged between 1½ and 2 percent.

Today, with inflation running at about 5 percent and interest rates in the private sector running from 10 to 14 percent and more, real rates are three to four times as high as in the typical post-war recovery. So in a sense, as far as easing money is concerned, we have only just begun to fight.

With present money-supply targets and the huge Federal deficits facing us, the prospects for sharp cuts in real rates are poor.

Both theory and experience teach that aggressive action by the Fed in an economy with huge unemployment and excess capacity can bring real rates down without reigniting inflation. Such a policy, without abandoning the commitment to stem inflation, would at long last remove the major risk of a further economic decline and a string of financial failures.

Fiscal policy faces an uncomfortable dilemma of timing in 1983. On one hand, further budget trimming and tax boosts are clearly needed to put the budget on a steady course toward balance or surplus at high employment, that is, to eliminate the present "structural" deficit that would run to about $75 billion at high employment by 1985.

On the other hand, as the foregoing review of economic prospects has shown, an economy that continues to sputter and operates nearly $300 billion below its potential well into 1983 can ill afford a sharp restriction in fiscal stimulus. The objective is gradually to take the foot off the fiscal gas as the economy expands, not to slam on the fiscal brakes at the first sign of recovery. The best policy mix would be a decisive easing of monetary policy coupled with fiscal steps to reduce the out-year deficits.

The balance of risks clearly favors policies to fight recession and support expansion. Even the White House forecasts project only a weak recovery and stubbornly high unemployment. Meanwhile, real progress has been made in bringing inflation to bay. So the case for shifting policy, especially Federal Reserve policy, to an expansionary stance now seems airtight.

The big question of the day is, has the Federal Reserve made this shift in the process of moving out from under M1 toward a separation—not yet a divorce—from its 3-year marriage to monetarism? I read the evidence much as the stock and bond markets have: The Fed has moved from its monetarist preoccupation with inflation toward a concern over fragile financial markets, intolerable unemployment, delayed recovery, and, just possibly, some effective prodding from Congress. This is good news not just for the financial community but for the U.S. economy in 1983.

[The bank letter referred to by Mr. Heller follows:]

FOR RELEASE WEDNESDAY A.M.'S, OCTOBER 13, 1982

NATIONAL CITY BANK
OF MINNEAPOLIS

October 13, 1982

U.S. ECONOMIC POLICY AND OUTLOOK

by

WALTER W. HELLER AND GEORGE L. PERRY

For 3½ years the American economy has been kept under wraps. Output today is lower than in early 1979, a performance that has added 5 million to the ranks of the unemployed and brought factory operating rates to their post-war low. It is hard to see the forces that will pull us out of this dismal swamp and push output above the early-1979 levels before 1983. This is by all odds our worst economic experience since World War II. We have traded double-digit inflation for double-digit unemployment.

We come to this bleak appraisal reluctantly. The recession we projected in this letter a year ago has already been deep and costly. But the second-half recovery we foresaw is simply not materializing. Policies that kept real interest rates at record levels in the teeth of a sustained recession have overwhelmed the stimulus of tax cuts, defense boosts, and lower inflation. The net impact is still unfolding in economic weakness in sector after sector of the U.S. economy. Before turning to those sectoral prospects, we examine the major source of that weakness: monetary policy.

MONETARY POLICY

The Federal Reserve's tight monetarist strategy of the past 3 years has kept real interest rates extraordinarily high at every stage of the cycle. This has not only pushed us into the present recession but could well prolong it. What we need now is more than just the letup in monetary stringency that comes naturally from a listless and financially fragile economy. We need an active pursuit of lower rates before things get worse.

True, we have had a welcome drop in rates since mid-year. Treasury bill rates are down 5 to 6 points, commercial paper rates are off by 4 to 5 points, and the prime rate has fallen 3½ points. The stickier interest rates on long-term bonds have fallen 2 points and mortgage rates about 1 point since mid-year.

The sense of relief these lower rates bring is offset by the apprehension that they are too little and too late to avoid a further softening of the economy. By any test of past experience, monetary policy is still far too restrictive for this stage of the business cycle. A simple comparison of *real* interest rates – market rates minus the inflation rate – drives this home:

- In the early years of previous post-war recoveries, real interest rates have averaged between 1½% and 2%.
- Today, with inflation running at about 5% and interest rates in the private sector running from 10% to 14% and more, real rates are 3 to 4 times as high as in the typical post-war recovery.
- Given present money-supply targets and the huge federal deficits facing us, the prospects for sharp cuts in real rates are poor.

Both theory and experience teach that aggressive action by the Fed in an economy with huge unemployment and excess capacity can bring real rates down without reigniting inflation. Such a policy, without abandoning the commitment to stem inflation, would at long last remove the major risk of a further economic decline and a string of financial failures.

The stock market has clearly been anticipating the further letup in Fed policy that would clear the track for economic recovery. But this is still in the realm of tomorrow's hope. Our projections are based on today's reality of repressively high real interest rates.

DELAYED RECOVERY

By rights, we should be in a cyclical recovery. Consumers have enjoyed a sizable tax cut, defense spending is on the move, inventories have been cut, inflation is down, interest rates have softened, and the upsweep in stock and bond prices has added $250 billion to people's assets.

But these economic pluses have been no match for the continued sources of weakness. Consumers are cowed by double-digit unemployment and growing layoffs. Manufacturers and distributors are still cutting inventories. State-local governments are retrenching. High mortgage costs continue to burden housing. Auto production schedules for the current quarter have been cut significantly. Business capital spending is reeling under the impact of weak markets and low-capacity utilization. And the combination of our strong dollar and weak economies abroad is sharply cutting net exports.

Barring unforeseen strength in consumer purchases or a sharp turn in Federal Reserve policy, we now expect recovery to be delayed until 1983. This will keep the official unemployment rate above 10% for months to come and will bring the comprehensive unemployment rate, embracing both part-time and discouraged workers, to 15% or more.

This grim job outlook will be paralleled by further declines in output, operating rates, and profits. Average operating rates in manufacturing will drop to only two-thirds of capacity. Profits, after declining 27% this year, will suffer further declines in the first part of 1983.

Signs of strength are hard to find as one looks across the individual sectors of the economy:

Consumer spending has not responded to the mid-year tax cut. One can hope that a delayed reaction to the tax cut, combined with lower consumer debt and the spectacular rally in security values, would still bring a recovery in consumer spending. But the worsening job market and stubbornly high borrowing costs have undermined consumer confidence and discouraged spending.

Housing starts recovered to an annual rate of a little over 1 million units during the summer. But until mortgage interest rates fall considerably further, the gains in home building will be very modest. One of the imponderables in the housing outlook is the impact of new legislation permitting savings institutions to compete with money market funds. The new law, coupled with the redeployment of funds from maturing All Savers' Certificates, is expected to increase the flow of funds into the mortgage market. If the more optimistic expectations of participants in residential financing are realized, a more vigorous housing revival may be in the cards.

Most discouraging is the snowballing weakness in *business investment*. Each survey of business investment intentions has been worse than the last. New orders for business capital equipment declined nearly 20% during the past year, and orders are still declining as sales and operating rates continue to fall short of expectations. Capital goods production is still falling at a 15% annual rate. Weakness in nonresidential building will become progressively worse in 1983 as present projects are completed and vacancies in commercial and office buildings discourage new construction.

The *net export balance*, after holding up remarkably well during the first half of this year – partly because recession reduced the demand for imports – declined sharply in the summer. The strong dollar makes U.S. goods less competitive and at the same time makes imported goods less expensive. Weakness in foreign economies will further cut into U.S. export demand. In particular, the financial crisis afflicting the Latin American economies will cut exports to this region. During the past four quarters, our merchandise trade balance with this region declined by $6 billion. It will decline substantially further in coming quarters as the Latin American nations are forced to limit their imports in order to meet the interest burden on their foreign debts.

The overdue *inventory* turnaround – from liquidation to accumulation – is not yet in sight. With orders, output, backlogs, and retail sales all falling well below expectations, business still finds itself with more inventories than it needs. The rate at which inventories were liquidated dropped from $36 billion in the first quarter to $16 billion in the second and still further in the third. This slowdown has two significant consequences:

- First, when businesses rely less on drawing down inventories to supply their customers, output grows even in the face of a drop in final sales. When businesses cut back their rate of inventory sell-off by $20 billion from the first to the second quarter, that translated into an automatic plus of $20 billion in the quarter-to-quarter change in GNP. This was the major factor in the posting of a 2.1% real GNP gain in the second quarter. A similar slowing of inventory liquidation also plays a major role in the Commerce "flash report" of a 1.5% real growth rate in the third quarter (which we believe will convert into a minus when the final numbers are in).
- Second, it means that businesses still have to work off unwanted inventories, thereby serving as a drag on output in the current quarter.

Inventory behavior is notoriously difficult to predict. If consumers snap out of their lethargy and the Fed aggressively eases credit, businesses will raise their target inventory levels thus requiring added output to satisfy their customers.

INFLATION

The miserable state of the economy has its counterpart in a brighter outlook for inflation. The tradeoff between unemployment and inflation still lives. Economic policies that have generated what will soon be 4 years of no-growth – nothing like it has been seen since the Great Depression of the 1930s – have also ground down the rate of inflation. No wonder. Even if we assume that our capacity to produce, our GNP potential, has been growing at only a bit over 2% per year – and many would put it at 2½% to 3% – actual output is running between $250 and $300 billion a year below our potential. This huge overhang of excess labor and plant capacity – together with the competitive pressure of falling import prices – has forced moderation in both wage and price behavior.

Add to this the impact of large crops on food prices, the impact of worldwide economic weakness on energy prices, the impact of deregulation on transportation prices and wages, and the impact of Federal Reserve policy on housing prices and now on mortgage rates, and it is not surprising that the overall picture is one of continued quiet on the inflation front.

The improvement shows up both in actual and in underlying rates of inflation. During the first 8 months of this year, average hourly earnings have been rising at a 6½% rate, the underlying rate of inflation in the CPI has dropped to 6%, and increases in the actual CPI have averaged 5.4%. Compared with the previous 12 months, these represent slowdowns of 1½, 2½, and 3½ percentage points, respectively. And inflation is still heading downward.

The critical question is whether the moderation in price and wage behavior will survive recovery. Rising demand, by definition, increases pressures for price increases. In the early stages of recovery, the hunger for increased profit margins can be satisfied from a drop in unit costs as more goods and services are produced with the existing capital equipment and labor force. But what about later on?

Much depends on whether consumers and workers recognize the full extent of the reduction in inflation to date and adjust their expectations of inflation downward. Survey after survey shows consumers still believing that inflation is significantly higher than it really is. And the combination of bulging federal deficits, painful past experience, and a certain cynicism has induced pessimism about the future course of inflation. Nevertheless, a number of factors suggest a sustained period of relief from a new round of inflation:

- Workers no longer have to play catch-up with the cost of living.
- Many of the industries with the strongest unions — for example, autos and steel — are subject to foreign competition and other structural pressures that are likely to bring wage and price increases in those industries to more moderate levels.
- Excess capacity and unemployment throughout the industrial world suggest a substantial cushion against renewed inflation as well as a muted rise in raw materials prices.
- With an oil glut abroad and a natural gas glut at home, energy prices are likely to be better behaved than had been anticipated.

THE FISCAL POLICY DILEMMA

Fiscal policy faces an uncomfortable dilemma of timing in 1983. On one hand, further budget trimming and tax boosts are clearly needed to put the budget on a steady course toward balance or surplus at high employment, that is, to eliminate the present "structural" deficit that would run to about $75 billion at high employment by 1985. (We use 5.6% unemployment as the definition of high employment, rather than the Congressional Budget Office's 5.1%. If Secretary Regan's 6% to 6½% range were accepted as the definition, the 1985 high-employment deficit would run over $100 billion.)

On the other hand, as the foregoing review of economic prospects has shown, an economy that continues to sputter and operates nearly $300 billion below its potential well into 1983 can ill afford a sharp restriction in fiscal stimulus. The objective is gradually to take the foot off the fiscal gas as the economy expands, not to slam on the fiscal brakes at the first sign of recovery. The best policy mix would be a decisive easing of monetary policy coupled with fiscal steps to reduce the out-year deficits.

Under the leadership of Senators Dole and Domenici, the Congress and White House compromised on a substantial tightening of budget policy last summer. These changes will boost revenues $40 billion by 1985, thus offsetting one-fifth of the 1981 tax cut. They will cut projected spending by a good deal more. Even though the total advertised spending cuts of $130 billion for 1985 — including such questionable items as $16 billion of unspecified "management savings" and $56 billion of savings from lower interest payments — appear exaggerated, the compromise was significant. It will bring about a substantial reduction in the 1984-85 deficits. Equally important, it represents a significant retreat by President Reagan from his previous adamant opposition to tax increases and modest cuts in the defense buildup. As modified by Congress, real defense purchases are now scheduled to rise just under 6% this year, about 6½% next year, and 7% in 1984.

With these changes factored in, what are the near-term prospects for the budget deficit?

- For fiscal 1982, just ended, the budget deficit will turn out to be slightly above the $105 billion we projected in this letter last February.
- For fiscal 1983, CBO projects the deficit at $155 billion, or $51 billion more than Congress had estimated. Part of the CBO adjustment comes from a more realistic assessment of likely expenditure savings from the recent budget compromise. About half of the difference comes from less optimistic assumptions about the path of the economy and interest rates.
- Given our even more pessimistic economic assumptions than those of CBO, we expect the 1983 deficit to be over $175 billion.

To gain more perspective on the fiscal policy dilemma and the budget-tightening moves that President Reagan will undoubtedly recommend in his budget message early next year, we should sort out how much of the deficit is a product of economic weakness, how much of it would persist at high employment, and what year-to-year changes are taking place.

- The bulk of the fiscal 1983 deficit is a child of the recession. If the economy were humming along at high employment, the deficit would be running, not at $175 billion, but at $40 billion, or 1% of GNP.
- If high employment were defined as 6.5% unemployment rather than the 5.6% we use, the 1983 high-employment deficit would be about $65 billion. It is worth noting, however, that the particular definition of high employment is not of great significance for measuring the impact of fiscal policy. It is the *swing* toward higher or lower deficits rather than the *level* of those deficits that measures the degree of fiscal stimulus or fiscal restriction.
- The swing toward deficits now projected for fiscal 1984 and 1985 after adjustment for the recent budget compromise is no longer very dramatic. The high-employment deficit moves up from 1% of GNP this year to 1.7% in those years.

How does this swing compare with other major swings toward high-employment budget deficits in the past 20 years?

- The first swing occurred with the buildup in Vietnam War spending under President Johnson. From a high-employment surplus averaging 0.7% of GNP in 1962-64, the budget moved into a high-employment deficit of 1.7% in 1967-68, a swing of 2.4 percentage points. This stimulated an economy already at full employment and is a well-documented example of perverse and inflationary fiscal policy.
- The next big swing, under President Nixon, was from a 0.1% surplus in 1969-70 to a 0.9% deficit in 1971-72, a shift that helped pull the economy back to full employment from a mild recession.
- The third swing, under President Ford, was a shift from a 0.6% high-employment deficit in 1973-74 to a 1.3% deficit in 1975-76. Again, this was a response to the steep recession that followed the first OPEC oil price explosion, a response that helped initiate recovery. It was a move in the right direction and was followed by a return to virtual high-employment balance in the budget under President Carter in fiscal 1979.

The swing we now project is no greater than those in the early and mid-seventies. It is scheduled to occur in an economy characterized by huge excess capacity and unemployment. While hewing to the goal of eliminating the high-employment deficit in the longer run, the White House and Congress should take care not to do too much too soon. As implied earlier, we do not want to slam on the brakes just when the economy is beginning to move again.

CONCLUSION

As our reappraisal of economic prospects makes clear, we believe that the odds on an economic recovery starting in the second half of this year have dropped considerably and that the odds on recession continuing into 1983 have correspondingly risen. To some extent, we are in uncharted waters, for the combination of a deep slump and high real interest rates has no precedent since the start of the Great Depression of the 1930s (when prices declined). All in all, then, there is considerable uncertainty and unease surrounding today's economic outlook.

But even if our best estimates prove too pessimistic, the balance of risks clearly favors policies to fight recession and support expansion. Even the rosy forecasts by the White House and Treasury project only a weak recovery and stubbornly high unemployment. And real progress has been made in bringing inflation to heel. So the case for shifting policy, especially Federal Reserve policy, to an expansionary stance now seems airtight.

As this is written, the indications are that the Fed has decided not to constrain the money supply during the current period of churning among various money market instruments. This could be just a short-term adjustment. But a number of observers believe that it may signify that the Fed is backing away from its exclusive emphasis on the monetary aggregates and shifting to a more accommodative posture. If this were to bring interest rates down substantially from current levels, we would project a considerably less bleak outlook for the U.S. economy.

Representative REUSS. Thank you, Mr. Heller.
Mr. Marshall.

STATEMENT OF RAY MARSHALL, PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, UNIVERSITY OF TEXAS, AUSTIN

Mr. MARSHALL. Thank you, Mr. Chairman, Congressman Hawkins.

I have a prepared statement which I have submitted for the record but will not read it. Therefore, I would like to summarize it, a task which is made much easier by my colleagues, who have done an excellent job of outlining a position that I agree with.

I think it is very clear that there is no easy solution to the problem of unemployment and other problems that face our economy. But experience suggests much better approaches than the combination of monetarism and supply-side economics, commonly known as Reaganomics, which clearly has failed and is not likely to work.

DEFECTS IN REAGANOMICS OUTLINED

The main defects in Reaganomics are, in my judgment, three:

First, it's based on unrealistic assumptions, lacking credible support in both economic theory and the experiences of industrial economies.

Second, it's very inefficient, relying on the theory that tax breaks for the wealthy and large corporations will "trickle down" to ordinary working people and the poor.

Third, it is extremely regressive in its impact on our society, redistributing wealth and power from the middle class and the poor to the rich and shifting more of the tax burden away from business and high-income groups and onto low- and middle-income consumers.

The economic consequences of the administration's policies are fairly clear.

The incapability of its monetarist policies and its supply-side policies have kept real interest rates very high and led us into the present "repression." It's not a recession because, as my colleagues have emphasized, it didn't just happen, it was caused by the policies of this administration. They halted the recovery that was underway in July 1981, leading to the present very difficult economic circumstances.

Contrary to President Reagan, unemployment was declining when he entered the White House, from 7.8 percent in July 1980 to 7.3 percent in December. It averaged 6.7 percent between 1977 and 1980, and has averaged 8.5 percent since that time.

The unemployment rate of 10.1 percent is only part of the problem. Altogether, there are about 19.5 million workers who are either discouraged, unemployed, or who are working part time when they would like to be working full time.

In addition, bankruptcies have quadrupled because many businesses cannot pay the real interest rates that we presently have.

And I think it's important to emphasize, as Walter Heller has done, that the real interest rates have not come down, that the CPI has declined much more than the nominal rates of interest and they remain far too high, and that this has caused trouble not only for the United States but for the entire world economy. In fact, the international economic situation, it seems to me, is one that we should be very, very concerned about. And part of that problem is caused directly by high interest rates in the United States.

Reduced expenditures for government infrastructure, nonmilitary research and development, information, and human resource development clearly will weaken our economy. The rate of inflation has moderated considerably, mainly because of the recession and smaller increases in energy, food, and import prices because of an overvalued dollar.

Now, as my colleagues have emphasized, to criticize these policies is like shooting fish in a barrel. They clearly will not work; history has demonstrated that. There is no support for the policies, either in logic or in experience.

ALTERNATIVE TO REAGANOMICS PROPOSED

The need, therefore, for a coherent, effective alternative to the failures of Reaganomics is urgent. A cogent alternative must realistically address the specific problems facing our economy: unemployment; inflation; high interest rates; low productivity growth; and now, the need for a rapid recovery from a deep economic recession. It must be fully comprehensive and internally coordinated, not just a string of band-aids and not a collection of contradictions, such as massive tax cuts to spur investment and high interest rates that choke off investment.

The preeminent objective of economic policies should be full employment. But first, in achieving this objective, we must recognize that general or macroeconomic policies, while the most powerful instruments of economic policy, cannot do the job alone. Well-honed macro policies must be matched by specific measures targeted to specific sectors and problems in our economy.

General credit, tax, and spending policies must be complemented in a major way by policies targeted to specific sectors.

Second, the solutions to economic problems should be built on a sensible division of labor between government, the market, and mechanisms that promote cooperative problem solving. And I would give heavy weight to the latter, because I think it's one of the main disadvantages the United States faces relative to other countries. And one of the reasons that our economic policies lack coordination and continuity is that we have no such mechanisms.

While the market can be a marvel of promoting short-run efficiency, it cannot solve larger problems. It cannot prevent recession, inflation, or create open end fair trade and competition. Markets, by themselves, cannot protect the environment, secure the health and safety of workers, eliminate discrimination, promote equal opportunities and adequate income for our people, foster our long-run basic research and innovation, and insure the national security.

Indeed, without government intervention to preserve competitive conditions, markets would be less effective than they are.

While we must rely primarily on market forces, there can be little doubt about the need for positive government partnership with the private sector in addressing important national problems. There is an important range of problems, particularly in fighting inflation and strengthening the international competitiveness of American industry, that will not yield to the uncoordinated actions of either the public or private sector alone. Public and private partnership must be forged, establishing a new institution of governance.

Third, a coordinated macropolicy, complemented by targeted sectoral policies developed on a cooperative basis, must be matched with strong policies directed toward our most pressing problems, fighting inflation, rebuilding our productive industrial base and, particularly after the recession of 1981–82, reducing unemployment.

The absence of specific anti-inflation policies in the Reagan program has left the entire burden of fighting inflation to monetary policy, with disastrous results of record real interest rates producing near depression conditions. Expanding supply and reducing costs in concentrated inflationary sectors can do a much more efficient job in lowering inflation, as can developing a consensus among industry, labor, and government on the appropriate interplay between prices, incomes, and economic policy.

Rebuilding our productive industrial base can make America's industries more competitive and its jobs more secure, while reducing inflationary pressures for the long run. And fighting the effects of recession through reducing unemployment can help us move more rapidly toward a healthy, stable economy.

Full employment means full utilization of our material resources, such as industrial plant and equipment, and the full employment of our human resources, a meaningful job for every person able to work. If done properly, this would do more than anything else to improve productivity and reduce inflationary pressures.

The policy mix should be heavily toward direct measures to reduce unemployment and selective policies in areas such as energy and transportation. Targeted investment and job creation on population groups, geographic areas and industrial sectors that are underutilized or where shortages now exist, or could exist, is good employment policy, good anti-inflation policy, and good social policy. Providing job skills and opportunities for all groups and regions is the single most important step that can be taken to improve education, combat crime, and enhance the standing of and opportunity for all of our citizens.

It's fashionable these days to argue that Federal employment and training programs have failed and cannot be effective instruments of national policy. Critics point out correctly that private sector employment and training is the best option for unemployment, but this option is not always available—especially when unemployment is over 10 percent—so, public employment and training is better than unemployment.

This negative assumption about selective programs continues to influence policy, despite numerous detailed, sophisticated evaluations to demonstrate that these programs were good public investments, despite incredible funding instability of these programs because of constant changes in laws and regulations and conflicting congressional mandates.

In order to overcome funding problems, new Federal employment and training programs must have greater funding stability—either through earmarking Federal funds, as is proposed by the Moynihan-Mathias national conservation bill to put young people to work in conservation projects, or forward funding of these programs in order to give them more stability.

In working out our monetary fiscal policy, we must, clearly, have much better coordination then we have had before. Because money is difficult to define and more difficult to control and because high and volatile interest rates, leading to recession, are the most likely result of restricting the growth of money supply, the focus of overall economic policy should not be on an input of policy; namely, money, but on the outcome of policy; namely, the gross national product. After all, money is merely a means to an end, real output.

Concentrating on GNP and employment will focus greater attention on the real ends of economic policy and require greater coordination to achieve those ends, because that is an objective that cannot be achieved by one economic agent, like the Federal Reserve, alone.

The most important immediate macro policy objective should be to reduce real interest rates. Indeed, the favorable output for near-term inflation and oil prices creates an excellent environment for the reduction of overall interest rates, an opportunity that will be missed by the Reagan economic program.

One inadequately appreciated benefit of such a policy is that it would allow interest rates to be lowered in other countries as well. The primary goal in monetary policy should be interest rates that are stable and just a little bit above the rate of inflation. High interest rates discourage capital investment. Lower, more stable rates would be the most effective and equitable means to stimulate investment and also reduce inflation by cutting the costs of borrowing.

Further, the large and unproductive expenditures required to pay interest on the huge Federal debt—now over $100 billion—would be significantly reduced.

A major defect of monetarism, as well as other policies that would rely on fixed formulas to control economic activities is their focus on means; that is, money or budget deficits—which destabilize outcomes—gross national product, employment, and investment. It would be much better to focus on outcomes.

The Congress, in cooperation with the Federal Reserve and the White House, and in consultation with such private sector groups as labor and management, should select compatible employment, growth and price targets and coordinate monetary and fiscal policies to achieve those objectives.

As the creature of the Congress, the Federal Reserve should not pursue a completely independent course and force the Congress to adjust economic policy goals to fit that course regardless of the outcome.

Indeed, the Humphrey-Hawkins Act requires the Federal Reserve Board to report on how its policies will respond to the goals set by Congress.

As I recall, when we were fighting to pass that bill, we felt one of the important outcomes would be to have more coordination. But there's very little evidence of it.

Some might object that increasing the money supply would fuel inflationary expectations and therefore increase, rather than lower, interest rates. But I do not accept that analysis. Increasing monetary growth probably would increase inflationary expectations in the long run, but a one-time increase in money growth would increase inflationary expectations only slightly, if at all, especially when combined with coordinated monetary and fiscal policies to stabilize interest rates, prices, economic growth, and employment.

As Don Nichols testified before this committee in June, an increase in the money supply probably would increase prices less than the increase in the money supply, causing an increase in the real money supply and probably would cause a substantial lowering of interest rates. You recall his estimate was perhaps a 3-percentage-point reduction for a 1-percent increase in monetary targets.

The American economy's economic performance has worsened considerably since the 1950's and 1960's, when policymakers concentrated on outcomes rather than budgets and the money supply. The present high interest rates are not because of inflationary expectations, but because of restrictive monetary policies in the fact of huge budget deficits. Inflationary expectations are about 6 percent according to a poll taken by the New York Stock Exchange.

I also applaud the recent action by the Federal Reserve, if it's really a change in course, to increase the money supply in order to try to bring the real rates of interest down. I do not, however, think this course is adequate, because it is not the consequence of a coordinated policy with the Congress and the White House on overall economic objectives.

Adjustments in this overall objective of monetary policy will be required as economic circumstances change.

NEED FOR MORE AUTOMATIC STABILIZERS

In order to enhance the flexibility of fiscal policy, several major changes should be adopted. I believe one of the most important ones is to adopt more automatic stabilizers because, as you well know, it takes a long time to get action by the Congress, and timing is terribly important. Forecasting is a very difficult problem.

I think we should have done a lot more to have automatic stabilizers and to have cyclically responsive employment and training programs. I think that's very important. I spell out some of the things that need to be done in my prepared statement, so I won't go into it.

Second, fiscal policy should be restructured to reduce or eliminate tax preferences that serve as incentives for speculation or unproductive investment. Likewise, expenditure programs should provide strong incentives for people to move from dependency to self-support.

Retraining disadvantaged workers or those dislocated by permanent layoffs with skills needed by industry are examples of proper program design. By simply cutting programs or reducing benefits for the working poor and, most important, providing a 95-percent tax on the earnings of welfare recipients, the Reagan program creates strong disincentives to either work or adjust to new economic situations.

Now, with respect to fighting inflation, I think the same kind of approach is needed. We need comprehensive macropolicy, but we also need to target on those sectors that cause the greatest trouble. I believe we also need to develop an equitable wage-price policy developed on a cooperative basis and a fair sharing of those sacrifices needed to bring inflation under control and to keep it under control if we do pursue a full employment policy.

Fourth, we need a policy to insulate the American economy as much as possible from external financial, energy, and food price shocks. This administration has no policy to deal with those problems, and those were very important causes of recent inflation and they could very well occur again, especially in the food area.

As a final sectoral concern, the acceleration of military spending proposed by the Reagan administration and endorsed by the Congress must be examined as an independent source of inflationary pressure.

A third element of our comprehensive anti-inflation policy is a mechanism for agreement among Government, labor, and industry at the highest levels on wage, price, and income growth rates that are consistent with steadily reducing overall inflation levels.

For such a consensus-based policy to work, all of the key players must take part directly; and all forms of income must be on the table, not just wages and prices, but rents, dividends, and interest as well.

The Government's role in such a system goes beyond enforcement to upholding its end of the bargain—fair and effective economic policy consistent with economic growth and reduced inflation.

Finally, I believe we need to develop an industrial policy to rebuild American industry.

CREATE NATIONAL ECONOMIC POLICY BOARD FOR COORDINATING POLICIES

The essence of a sound economic policy in the future will be to integrate the wide variety of public and private sector decisions that bear on the Nation's capacity to achieve full employment, economic growth, and stable prices. A means must be created to establish and discuss realistic long-term goals, review private sector responses to public sector stabilization policies, resolve conflicting objectives and construct the proper mix of general and selective policies. To be effective, such discussions must involve all the major concerned parties—industry, labor, and the Government.

We've had considerable experience with the tripartite mechanisms, and they have been successful. I don't know why we don't try to build on the experiences that we've had in this country and other countries. Since the existing formal and informal institutions are not sufficient, however, a National Economic Policy Board should be created. The members of the Board would include labor, business, Government, and independent experts. The Federal Reserve Board also should plan an active role in any such activity. First, the NEP board should provide a means through which discussions would be held regularly on economic performance and forecast, stabilization policies and the reaction of private sector institutions.

In addition, it would be a major mechanism for providing continuity of economic policy, particularly as administrations change.

Second, the board would provide the right framework for working out an incomes policy needed in the fight against inflation. It is not at all clear that a wage-price policy can be made to work. There are enormous difficulties, but I am convinced that the only time that can work is when there is broad consensus among major economic factors, and we need some mechanism to do that. The NEPB could also be the vehicle for framing a coherent industrial policy. The United States already has an industrial policy, but it is not coherent. It is not the result of clear and systematic thinking. Trade policy, taxes, regulation, energy, and even interest rates have a significant impact on the structure of the economy and the opportunities or lack of them for industries and firms.

In order to resolve structural problems, anticipate future needs, and integrate sectoral policies with stabilization policies, it is time to coordinate these decisions, and at the least, understand their consequences.

One of America's major disadvantages relative to countries like Germany and Japan is its failure to develop systematic industrial policies. In fact, foreign export driven industrial policies, in the absence of a more systematic U.S. industrial policy, have undermined the future of American industry in sectors ranging from steel and machine tools to semiconductors and fiber optics. The core of American industry will not long survive such unequal competition.

INDUSTRIAL POLICY GOAL OF MAXIMIZING ECONOMY-WIDE GROWTH POTENTIAL AND COMPETITIVENESS

I also agree with Professor Galbraith that we need to have a lender of last resort. Industrial Development Bank, I think, would be an important part of this overall policy.

Let me emphasize that the concept of industrial policy does not imply picking the winners or picking the losers among industries or regions. I believe that that is purely a hypothetical argument that people raise against such policy. To the contrary, our goal should be to maximize the growth potential and competitiveness of every part of our economy. This means providing needed stimulus to basic industries like steel and autos and high-growth, high technology industries, such as large-scale semiconductors, where aggressive foreign industrial policies threaten to wipe out the lead the United States established in the 1970's.

Two of the main arguments against an industrial policy are that it cannot be insulated from political pressures which would cause it to support inefficient industries, and that American Government and society are too fragmented and adversarial to support such a policy.

I think both of these arguments are wrong. You can insulate the mechanism from undue political pressures. In fact, the second argument that we're too fragmented and adversarial makes the case for such a policy, because I believe an industrial policy and a consensus-building mechanism could help overcome the excessive adversary relationships that currently damage our economic performance.

Another important part of this is to recognize, as you, Mr. Chairman, and several of my colleagues have emphasized, that the public infrastructure investment is also vital to strong productive growth. Our bridges, ports, water systems, not to mention rail beds, tracks, and rolling stock are in urgent need of upgrading. I invite your attention to the work by Pat Choate and Susan Walter, who completed a survey of urgent infrastructure investment needs totaling over $3 trillion for the 1980's and 1990's.

Countries such as France and Japan have used public investment in profitable high-speed rail transportation as a spur to new industrial innovation and export, in addition to their direct beneficial impact on improved domestic transportation.

Finally, it must be recognized that the greatest single determinant of business investment in new productive plant and equipment is not special tax gimmicks but rather steady growth of demand and avoidance of recession.

Moving our economy toward full employment is the single most important contribution we can make toward strengthening industry and improving productivity growth. Thank you, Mr. Chairman.

[The prepared statement of Mr. Marshall follows:]

PREPARED STATEMENT OF RAY MARSHALL

There are no easy solutions to the unemployment problem, but experience suggests much better approaches than the combination of monetarism and supply side economics, commonly known as Reaganomics, which clearly has failed and is not likely to work. The main defects of Reaganomics are:

(1) It is based on unrealistic assumptions, lacking credible support in both economic theory and the experience of industrial economies;

(2) It is very inefficient, relying on the theory that tax breaks for the wealthy and large corporations will "trickle down" to ordinary working people and the poor;

(3) It is extremely regressive in its impact on our society, redistributing wealth and power from the middle class and the poor to the rich and shifting more of the tax burden away from business and high income groups and onto low- and middle-income consumers.

The economic consequences of the Administration's policies are fairly clear:

(1) The huge 1981 tax cut (based on the assumption that reducing marginal tax rates for corporations and higher income groups would greatly stimulate the economy and balance the budget by 1984) was a seriously flawed concept that merely increased stock sales, personal savings, and the sale of luxury goods and stimulated speculation and mergers while doing little to increase job-creating investments. In fact, business investment in 1982 declined relative to 1981 an estimated 4.4%. The sale of luxury goods increased because high income groups were made better off by Reaganomics, but we cannot sustain an economy on the basis of the sale of yachts, million-dollar houses, and the brokerage business. With rising unemployment and uncertainty caused by the Administration's radical economic policies, consumer demand is inadequate to sustain the economy. Moreover, the high real interest rates resulting from the Administration's budget deficits and tight money policies restrain both investment and consumer demand.

(2) The causes of high and fluctuating interest rates are fairly clear.

The tax cut reduced government revenues, creating a huge budget deficit despite the $98.6 billion 1982 tax increase. (In fact, this tax increase, following the large tax cut the previous year, added to the public's confusion and uncertainty over economic policy.) The budget deficit increases the government's demand for money at the same time that the Federal Reserve Board's restrictive monetary policies greatly limited the funds available to the government and those borrowers who are forced to rely on the banks (mainly small business, home builders, auto dealers, home buyers and purchasers of consumer durables). The consequence of greatly reducing the supply of money and increasing its demand is to cause very high real interest rates--the consumer price index has declined much more than nominal interest rates. High real interest rates have had disastrous national and international consequences:

(1) They halted the recovery that was underway in July 1981, leading to the present deep recession. Contrary to President Reagan, unemployment was declining when he entered the White House--from 7.8% in July 1980 to 7.3% in December. It averaged 6.7% between 1977 and 1980 and has averaged 8.5% since that time. In addition, bankruptcies have quadrupled because many businesses cannot pay real rates of interest approximating 7-10% (the long-term real rates have been between 2 and 3%) when inflationary expectations have declined to less than 6%. Moreover, not even large profitable businesses are likely to invest, especially during periods of such uncertainty, when high real rates can be earned on short-term, relatively riskless securities. A major source of instability results from the fact that large firms that finance internally (only 23% of investments came from personal savings in 1980) are less sensitive to interest rates and the availability of money than smaller firms.

(2) High interest rates also cause trouble in international financial markets. International financial crises could cause very serious disruptions for the U.S. and other world economies. High interest rates cause the dollar to be overvalued, which subsidizes imports and reduces our exports by causing our products to be overpriced in world markets. This overvaluation gives some temporary relief from inflation by limiting import prices, but contributes to unemployment in export industries. This is, moreover, a very unstable arrangement, because our export imbalance will ultimately lead to pressures to

devalue the dollar as it did during the early 1970s, at which time higher import prices will produce inflationary pressures. Unfortunately, the Administration's laissez-faire policies make it unwilling to intervene to prevent wide fluctuations in exchange rates.

(3) The deficits induced by the Administration's tax cuts also have caused deep cuts in important government programs. Moreover, the Administration's New Federalism would shift the responsibility for public programs to the states while reducing the funds available to pay for those programs. Since the states do not have adequate revenue sources, they will have to raise generally regressive taxes or discontinue services. The "New Federalism" also would risk competitive devaluation of programs as states compete with each other for industry during periods of high unemployment. There also is no guarantee that there will be constituencies at the state and local levels for such national objectives as combatting discrimination and serving the disadvantaged.

(4) Despite the Administration's rhetoric about getting the goverment off our back, Federal expenditures will probably increase relative to GNP above what they would have been if the 1981 tax measures had never been adopted.[1] The mix will merely shift from domestic programs to defense spending.

Reduced expenditures for government infrastructure, nonmilitary research and development, information, and human resource development clearly will weaken our economy. The real secret of America's economic success has been investment in its people. Unfortunately, the Administration's budget deficits and laissez-faire philosphy force it to reduce these investments. Indeed, it is unfortunate that the Administration views goverment non-defense expenditures as of no value instead of as public investments.

The rate of inflation has moderated considerably, mainly because of the recession and smaller increases in energy, food and import prices. However, the recession has been very costly. In order to reduce inflation by one percentage point, it is necessary to increase unemployment by one milllion and hold it for 2 years at a cost to national output of $200 billion for each percentage point reduction in the CPI and an increase in the Federal deficit of $30 billion for each 1 percentage point increase in unemployment.

THE FULL EMPLOYMENT ALTERNATIVE

The need for a coherent, effective alternative to the failures of Reaganomics is urgent. A cogent alternative must realistically address the specific problems facing our economy: unemployment, inflation, high interest rates, low productivity growth, and, now, the need for rapid recovery from a deep economic recession. It must be fully comprehensive and internally coordinated, not just a string of band-aids and not a collection of contradictions such as massive tax cuts to spur investment and high interest rates that choke off investment.

Without any credible single explanation for complex economic problems, and without a painless short-term miracle cure, nothing short of a policy that employs a variety of measures tailored to the multiple causes of inflation and unemployment can be successful. The policy must recognize the complex nature of the economy, complement and sometimes supplant general policies with selective and sector-specific ones, encourage experimentation, and adopt a longer run perspective. In short, macro or stabilization policies must be married to micro and supply-oriented policies. These combined approaches should be structured with equity as an important concern.

An effective alternative policy for the 1980s cannot be a return to the economic policies of previous Administrations or the almost exclusively macroeconomic version of Keynesian demand management theories. The latter had created an intellectual opening for ill-founded supply-side and monetarist ideas.

First, we must recognize that general or macroeconomic policies, while the most powerful instruments of economic policy, cannot do the job alone. Well-honed macro policies must be matched by specific measures targeted to specific sectors and problems in our economy. For example, macroeconomic measures to stabilize economic performance, while reasonably successful during most of the post-war period, have become increasingly ineffective under the conditions we have experienced since the end of the 1960s. Energy price shocks for imported oil in 1974 and 1979 increased prices throughout the economy as a result of indirect energy cost impacts and high interest rates caused by tight money policies designed to fight an energy-induced inflation. The subsequent increase in the overall price level moved economic authorities to restrain fiscal policy and to further tighten monetary policy. The results were the stagflations of 1974-1975 and 1980. In each of these recessions, the unemployment rate soared higher, and in the recovery, unemployment remained higher than before. The recession of 1981-1982, the product of exclusively (and misdirected) macroeconomic measures, has become the worst downturn since the Great Depression.

General credit, tax, and spending policies must be complemented in a major way by policies targeted at particular sectors. One supply-side complaint about Keynesian economics as practiced in the 1970s is largely valid. Keynesian policies have sometimes tended to ignore resources, productivity and other "supply" concerns. All economists must be concerned with both supply and demand, and particularly during periods of recession, we must concentrate on improving our productive resources, both material and human. These problems must be addressed, but without both demand management and targeted sector programs, full employment and stable prices will not be possible.

Second, the solutions to economic problems should be built on a sensible division of labor between government, the market, and mechanisms that promote cooperative problem-solving. While the market can be a marvel at promoting short-run efficiency, it cannot solve larger problem. It cannot prevent recession, inflation, or create open and fair trade and competition. Markets by themselves cannot protect the environment, secure the health and safety of workers, eliminate discrimination, promote equal opportunities and adequate income levels for households, foster long-run basic research and innovation, and ensure national security. Indeed, without goverment intervention to preserve competitive conditions, markets would be less effective than they are.

While we must rely primarily on market forces, there can be little doubt about the need for a positive government partnership with the private sector in addressing important national problems. There is an important range of problems--particularly in fighting inflation and strengthening the international competitiveness of American industry--that will not yield to the uncoordinated actions of either the public or private sector alone. Public and private partnerships must be forged, establishing a new institution or governance.

Third, a coordinated macro policy complemented by targeted sectoral policies developed on a cooperative basis must be matched with strong policies directed toward our most pressing problems: fighting inflation, rebuilding our productive industrial base, and, particularly after the recession of 1981-1982, reducing unemployment.

The absence of specific anti-inflation policies in the Reagan program has left the entire burden of fighting inflation to monetary policy, with disasterous results of record real interest rates producing near depression conditions. Expanding supply and reducing costs in concentrated inflationary sectors can do a much more efficient job in lowering inflation, as can developing a consensus among industry, labor, and goverment on the appropriate interplay between prices, incomes, and economic policy. Rebuilding our productive industrial base can make America's industries more competitive and its jobs more secure while reducing inflationary pressures for the long run. And fighting the effects of recession through reducing unemployment can help us move more rapidly toward a healthy, stable economy.

The preeminent goal guiding economic policy should be full employment. Full employment means the full utilization of our material resouces, such as industrial plant and equipment, and the full employment of our human resources--a meaningful job for very person able to work. If done properly, this would do more than anything else to improve productivity and reduce inflationary pressures. The policy mix should be heavily weighted toward direct measures to reduce unemployment, and selective policies in areas such as energy and transportation. Targeting investment and job creation on population groups, geographic areas, and industrial sectors that are underutilized or where shortages now exist, or could exist, is good employment policy, good anti-inflation policy, and good social policy. Providing job skills and opportunities for all groups and regions is the single most important step that we can take to improve education, combat crime, and enhance the standing of and opportunity for all our citizens.

It is fashionable these days to argue that Federal employment and training programs have failed and cannot be effective instruments of national policy. Critics point out correctly that private sector employment and training is the best option for unemployment, but this option is not always available--especially when unemployment is over 10%--so public employment and training is better than unemployment. This negative assumption about selective programs continues to influence policy, despite numerous detailed evaluations to demonstrate that these prorams were good public investments, despite incredible instability because of constant changes in laws and regulations and conflicting Congressional mandates. In order to overcome these funding problems, new Federal employment and training programs must have greater funding stability--like earmarked Federal funds (as suggested in the Moynihan-Mathias National Conservation Bill to put young people to work in conservation projects, which would earmark revenues from Federal parks and forests for this purpose).

Coordinating Monetary and Fiscal Policy

Because money is difficult to define and more difficult to control, and because high and volatile interest rates leading to recession are the most likely result of restricting growth of the money supply, the focus of overall economic policy should be the level of GNP. After all, money is merely a means to an end--real output. Concentrating on GNP and employment will focus greater attention on the real ends of economic policy and require greater coordination to achieve those ends. The most important immediate macroeconomic policy objectives should be to reduce real interest rates. Indeed, the favorable outlook for near-term inflation and oil prices creates an excellent environment for the reduction of overall interest rates--an opportunity that will be missed by the Reagan economic program. One inadequately appreciated benefit of such a policy is that it would allow interest rates to be lowered in other counries, particularly in Europe and the Third World; there, as here, lower interest rates would help stimulate output and alleviate unemployment, thus raising overseas demand for U.S. export industries.

The primary goal of monetary policy should be interest rates that are stable and just a little above the rate of inflation (unlike the 1981-1982 interest rates ranging from six to 12 points above the inflation rate). High interest rates discourage capital investment; lower, more stable rates would be the most effective and equitable means to stimulate investment and also reduce inflation by cutting the costs of borrowing.

Further, the large and unproductive expenditures required to pay interest on the huge federal debt--now over $100 billion annually--could be significantly reduced.

A major defect of monetarism as well as other policies that would rely on fixed formulas to control economic activities is their focus on means (money or budget deficits) which destabilize outcomes--gross national product, employment, investment. It would be much better to focus on outcomes. The Congress, in cooperation with the Federal Reserve and the White House and in consultation with such private sector groups as labor and management, should select compatible employment, growth and price targets and coordinate monetary and fiscal policies to achieve these objectives. As the creature of the Congress, the Federal Reserve should not pursue a completely independent course and force the Congress to adjust economic policy goals to fit that course regardless of the outcome. Indeed, the Humphrey-Hawkins Act requires the Federal Reserve Board to report on how its policies will respond to the goals set by Congress.

Some might object that increasing the money supply would fuel inflationary expectations and therefore increase rather than lower interest rates, but I do not accept that analysis. Increasing monetary growth probably would increase inflationary expectations in the long run. But a one time increase in money growth would increase inflationary expectations only slightly, if at all,[2] especially when combined with coordinated monetary and fiscal policies to stabilize interest rates, prices, economic growth and employment. As Don Nichols testified before this Committee in June, an increase in the money supply probably would increase prices less than the increase in the money supply, causing an increase in the real money supply and probably would cause a substantial lowering of interest rates (perhaps a 3 percentage point reduction for a 1 percent increase in the monetary target.[3] As Nichols demonstrates, economic performance has worsened considerably since the 1950s and 1960s when policymakers concentrated on outcomes rather than budgets and the money supply. The present high interest rates are not because of inflationary speculations, but because of restrictive monetary policies in the face of huge budget deficits--inflationary expectations are about 6% according to a poll by the New York Stock Exchange.[4]

The Federal Reserve Board apparently has recently temporarily relaxed its monetary restrictions by focusing on M_2 and M_3 as well as M_1; while this is welcome, it is no substitute for an effective and coordinated monetary policy to support economic outcome goals.

Adjustments in this overall objective of monetary policy will be required as economic circumstances change. However, it is fiscal policy that should be the primary tool for restraining aggregate demand when it begins to outstrip capacity and generate inflation (or, conversely, stimulating demand when underutilized capacity and high unemployment need to be counteracted). Since high interest rates can reduce inflation only in interest-sensitive sectors of the economy and then only by reducing productive investment and increasing unemployment and lowering sales, the ongoing fight against inflation should be waged more directly with targeted anti-inflation programs rather than with exclusive reliance on across-the-board tight money policies.

In order to enhance the flexibility of fiscal policy, several major changes should be adopted. First, automatic stabilizers such as unemployment insurance must be recognized as the most effective means to sustain purchasing power and cushion the impact of an economic downturn. Due to the length of the budget cycle (usually more than a year to complete both Executive and Congressional action) and economic forecasts that generally are not very accurate beyond two quarters in the future, discretionary policy--spending or taxing--is very difficult to implement in a timely fashion. In addition, policy changes that are intended to be temporary often have a way of becoming permanent.

Consequently, fiscal policy should be designed to be much more cyclically responsive. New automatic stabilizers that directly create jobs should be developed. They would include jobs and training, public works, and revenue sharing. Expenditures for these programs would be triggered on when unemployment rises to a certain level, for example 6 percent, and shut off when it drops below this level. This distribution formula would ensure that groups and areas with particularly high unemployment rates would be the primary beneficiaries. Tax policy could also be revised to contain a countercyclical dimension to promote increased investment training and job creation during recessions. Conservatives who do not trust government and the political process prefer rigid formulas for increases in the money supply or a constitutional amendment to require balanced budgets. These would be automatic destabilizers rather than the automatic stabilizers advocated here.

The 10.1 percent unemployment, which could rise to 11%, and the current disaster in the construction, auto, and other interest-sensitive industries painfully show the need to implement a more responsive and stimulative fiscal policy. In 1981, fiscal policy was actually restrictive on a high-employment budget standard, and it remained restrictive through the first half of 1982. According to the Congressional Budget Office, each 1 percent rise in unemployment increases the federal budget deficit by about $30 billion (roughly $11 billion in increased outlays and $19 billion in lost revenues). Moving even to a modest 6 percent unemployment from 10 percent would therefore reduce the current federal deficit by some $120 billion. deficits of 1981 and 1982. Moving to 5 percent unemployment would improve the budget by a full $150 billion. surplus. With the fiscal brakes on and the monetary brakes applied vigorously by the Federal Reserve Board, the 1981-1982 recession was as deliberate as it was unnecessary.

Second, fiscal policy should be restructured to reduce or eliminate tax preferences that serve as incentives for speculation or unproductive investment. Tax giveaways to the wealthy such as "All Savers Certificates" and misdirected business incentives that generate little or no increased savings and investment for our economy must be replaced with targeted incentives that are both efficient and fair. Likewise, expenditure programs should provide strong incentives for people to move from dependency to self support. Retraining disadvantaged workers or those dislocated by permanent layoffs with skills needed by industry are examples of proper program design. By simply cutting programs or reducing benefits for the working poor, and providing a 95% tax on the earnings of welfare recipients, the Reagan program creates strong disincentives to work or adjust to new economic conditions.

Caution should be exercised on the tax side. Overly ambitious tax cuts imposed as part of President Reagan's tax bill extend for years into the future, cutting government income below viable levels, and reducing the stabilizing power of the federal budget. The virtual elimination of the corporate income tax and a 25 percent cut in personal income taxes is simply fiscal irresponsibility. Increased revenue for future years is needed. It might most effectively be raised by closing loopholes, eliminating the automatic tax cuts for years after 1984, and finding less costly substitutes for the highly inefficient supply-side tax cuts for corporations and the well-to-do. The stated objectives of the supply-side tax program--incentives for savings and productive investment--can certainly be achieved without unfairly skewing income distribution and without bankrupting the federal government. Indeed, realizing the social dividend from a full employment economy would be much more effective. Further, targeted incentives for productive investment in physical capital (plant and equipment) should be matched with incentives for investment in human capital, particularly for education and skills and job training. Public investment and incentives for employment and training have the advantage of adding to productivity without unfairly tilting the distribution of income.

Finally, the current federal deficit should be replaced in public debate with more meaningful measures of stimulus to the economy or of the impact of government on the private economy. The size of the U.S. budget deficit bears little relationship to our inflation rate over the past several years. Moreover, countries such as Japan and Germany have much lower inflation rates with much higher government deficits than ours. High deficits are a natural and largely unavoidable result of continuing slow growth and excessive unemployment. Moreover, the size of the deficit is doubly distorted by high inflation and high interest rates; over the past decade, outlays for debt service have been the fastest growing major segment of the budget, rising at an annual rate of 19 percent compared with 15 percent for income transfer programs and 11 percent for the budget as a whole. This year alone, the federal government will spend more than $110 billion on interest payments--trailing only the military and Social Security among federal expenditures.

Fighting Inflation

A comprehensive anti-inflation policy should combine four basic inflation-fighting strategies (none of which are used in the Reagan program):

(1) A balanced general economic policy aimed at steady growth, strong investment in physical and human capital, and high levels of capacity utilization;

(2) A targeted sectoral program designed to increase supply, and reduce costs, and improve efficiency in inflation-leading sectors;

(3) An equitable wage-price policy developed on a cooperative basis and based on a fair sharing of the sacrifices needed to bring inflation under control; and

(4) A policy to insulate the American economy as much as possible from external financial and energy and food price shocks.

The most appropriate macroeconomic policy for the fight against inflation is summarized in the previous section. General macroeconomic policies alone, however, cannot meet specific inflationary pressures in our economy. The inflation we have endured in the 1970s and early 1980s is not the classic textbook case of inflation in an over-heated economy, where many product and labor markets are pushed up against their capacity limits.

A policy of excessive monetary and fiscal restraint cannot succeed against the sectoral causes of inflation, or will succeed only by accident and at great unnecessary cost to the economy and the people. Simply stated, recession is not the solution. Indeed, recession only exacerbates the long-run inflation problem by cutting investment in human resources and new productive capacity.

An anti-inflationary policy for a primarily sectoral inflation should focus on the four sectors that account for 60 percent of U.S. inflation:

1. Energy: Encouraging energy conservation of all kinds, residential, industrial, commercial, transportation, etc., promoting the development of new domestic supplies, particularly those of a renewable nature, and building up petroleum reserves as rapidly as possible to reduce vulnerability to external energy supply and price shocks.
2. Housing: Actively expanding--not restricting--new supply and developing technologies for reducing costs in the construction of new housing.
3. Food: Using periods of high production and low price to build grain reserves domestically and internationally, and developing a grain export board, as used in the other two leading grain exporting countries, Canada and Australia, to manage export sales to large foreign buyers.
4. Health Care: Encouraging further preventive health care through health maintenance organizations (HMOs) and moving toward a system of national health insurance that will reduce rates of illness and disease and contain the costs of treating them.

As a final sectoral concern, the acceleration of military spending proposed by the Reagan Administration and endorsed by Congress (7 percent annually in real terms) must be examined as an independent source of inflationary pressure. The reason defense spending is so inflationary lies in the nature of the procurement process. The procurement process is hardly subject to the competitive pressures of the marketplace; 60 percent of military procurement is sole source and only 8 percent is based on competitive bids. The magnitude of the defense procurement problem is illustrated by the fact that during the last three months of 1980 alone, the overrun on 40 weapons systems totalled $47.6 billion, about equal to the Administration's entire domestic budget cuts for 1982. The defense sector can drain capital away from productive civilian industries and away from other government programs; it shifts key human resources, such as scientists and engineers, as well as scarce materials away from the civilian economy. These resource shortages bid up prices, thereby increasing inflation. While we must maintain an adequate national defense, we must also seek to lessen the crushing impact of rapidly escalating military spending. We also should vigorously pursue arms reduction and disarmament negotiations and persuade our overseas allies to shoulder a fair share of the defense burden.

The third element of a comprehensive anti-inflation policy is a mechanism for agreement among government, labor, and industry at the highest levels on the price, wage, and income growth rates that are consistent with steadily reducing the overall inflation levels. For such a consensus-based policy to work, all the key players must take part directly; and all forms of income must be on the table--not just the wages or prices, but rents, dividends, and interest as well. The goverment's role in such a system goes beyond enforcement to upholding its end of the bargain--fair and effective economic policies consistent with economic growth and reducing inflation. The foundation of the success of such a system is a participatory process for making decisions and a fair sharing of sacrifices in implementing the results. Americans are ready to accept sacrifice in bringing down inflation, but only if they see all of us sharing the burden. This perception does not exist under Reaganomics.

Rebuilding American Industry

The essence of sound economic policy in the future will be to integrate the wide variety of public and private sector decisions that bear on the nation's capacity to achieve full employment, economic growth and stable prices. A means must be created to establish and discuss realistic long-term goals, review private sector responses to public sector stabilization policies, resolve conflicting objectives, and construct the proper mix of general and selective policies. To be effective, such discussions must involve all the major concerned parties--industry, labor, and government.

Such consultative forums have worked well in this country. The Steel Tripartite Committee, formed in 1977, brought together the leadership of the steel industry, labor, and the heads of the government agencies to examine the industry's problems of international trade, occupational safety and health, environmental protection, investment taxes, plant closings and worker/community adjustment programs, and new technology for steel production. In the summer of 1980, the Steel Tripartite Committee made a wide-ranging set of recommendations to the President, many of which were accepted, leading to the widely acclaimed "steel stretch-out" for meeting environmental deadlines and other policy changes. The Construction Industry Coordination Committees have brought together labor, construction management, and concerned government officials to develop ways to reduce the extreme seasonal fluctuations in construction activity--fluctuations that add to inflationary pressures by creating manpower and resource shortages in the construction industry. Other recent examples include the airline and coal industries. For more general economic policy consultation among business, labor, and government we have the examples of the Reconstruction Finance Corporation (RFC) and the War Production Board from the 1930s and 1940s.

Bringing together the experience and expertise of labor, management, government and others with a stake in the future of our economy would undoubtedly improve our ability to target scarce resources and revitalize our economy. In may areas we suffer not from a shortage of resources, such as investment capital, but rather from an inefficient allocation of those resources among industries and among users. The challenge today calls for a forum for building a policy consensus to address such necessary questions as inflation and the reconstruction of our aging and weakened industrial base, including transportation, communication and energy-providing facilities.

It is often observed that Japan, Germany and other European countries such as Austria and the Netherlands were given a great boost in their industrial capability as a result of having this capacity destroyed during World War II. In fact, those countries are now into their third and fourth generation of industrial equipment; this supposed "advantage" of total military devastation lies far in the past and does not account for their economic strength today. But one enduring gain these countries did receive from this experience was a recognition by all of the groups in their societies that they had to work together to restore their shattered economies. These countries quickly produced consensus-building institutions for joint consultation, concerted action, and in some cases joint decision-making on the future of their industries, regions, and national economies.

Since existing formal or informal institutions are not sufficient, a National Economic Policy Board (NEPB) should be created. The members of the board would include labor, business, government, and independent experts. The Federal Reserve Board also should play an active role.

First, the board would provide a means through which discussions could be held regularly on economic performance and forecasts, stabilization policies and the reaction of private sector institutions. In addition, it would be a major mechanism for providing continuity in economic policy, particularly as Administrations change.

Second, the board would provide the right framework for working out the incomes policy needed in the fight against inflation. The major elements of the economy would be represented, and in the board they would also have responsibility for the overall economic policies into which successful wage and price policies must fit.

It is not at all clear that a wage-price policy can be made to work. There are formidable operational problems to any such policy--whether a tax-based incomes policy or direct wage and price controls. Nevertheless, if the alternative is either escalating inflation or high levels of unemployment, it is important to attempt to gain consensus on some wage-price policy. I would stress the consensus process rather than a specific formula, because without consensus no system will either be adopted or work satisfactorily.

Third, the board would be the vehicle for framing a coherent industrial policy. The U.S. already has an industrial policy, but it is not the result of clear and systematic thinking. Trade policy, taxes, regulations, energy, and even interest rates have a significant impact on the structure of the economy and the opportunities, or lack of them, for industries and firms. In order to resolve structural problems, anticipate future needs, and integrate sector policies with stabilization policies, it is time to coordinate those decisions and at the least understand their consequences. One of America's major disadvantages relative to Germany and Japan is its failure to develop a systematic industrial policy. In fact, foreign export-driven industrial policies--in the absence of a more systematic U.S. industrial policy--have undermined the future of American industry in sectors ranging from steel and machine tools to semiconductors and fiber optics.

The core of American industry will not long survive such unequal competition. The work of the board and its industry committees should be augmented by an industrial development bank to channel investment into long-term economic development. Such a bank could be financed largely by private resources with special consideration given to using pooled pension fund money. However, it would be in the national interest for the bank to receive appropriated funds and be authorized to borrow additional funds. The development bank could combine existing Federal credit programs and should give special attention to the credit needs of small businesses and state and local governments. The bank could be patterned after the successful Reconstruction Finance Corporation established in 1932.

The concept of industrial policy does not imply "picking the winners" or "picking the losers" among industries or regions. To the contrary, our goal should be to maximize the growth potential and competitiveness of every part of our economy. This means providing needed stimulus to basic industries like steel and auto and to high-growth, high-technology, industries such as large-scale semiconductors, where aggressive foreign industrial policies threaten to wipe out the lead that the U.S. established in the 1970s, which has been seen in the textile industry, now a net exporter of some $3 billion annually, reinvigorating established industries whose competitive position has been eroded in part by a failure to install modern equipment and technology.

Two of the main arguments against an industrial policy are that it cannot be insulated from political pressures which would cause it to make decisions to support inefficient industries and that the American government and society are too fragmented and adversarial to support industrial policies. With respect to the first, it is not at all clear that a political decision based on Congressional review is inferior to economic decisions based on short-run market considerations that would destroy basic industries, or subject them to unfair competition from abroad. Even so, it would be possible to insulate the bank from undesirable political pressures as has been done with the Federal Reserve Board.

With respect to the second argument, it is true that American economic policy is too fragmented and government relations with the private sector are too adversarial, but that is precisely why such a mechanism is needed--to overcome these problems. Coordination and consensus building are not easy, but they probably are essential to economic stability, growth, international competitiveness and the full use of our human and material resources.

As the textile and steel industry examples demonstrate, many elements of a successful industrial policy do not involve providing capital subsidies to business. Targeting R&D toward areas with commercial promise, adjusting trade policy (including forcing other countries to lower unfair barriers to U.S. goods), providing antitrust waivers for joint R&D activities in large-scale industries, and adopting environmental and other regulatory requirements to specific conditons in individual industries (e.g., the "steel stretch-out" legislation for industry clean air compliance) illustrates the variety of cost-free instruments of industrial policy. Our nation needs to target limited economic resources in a way that will assure healthy industrial development and full employment for the American economy of the 1980s and beyond.

Public infrastructure investment is also vital to strong productivity growth. Our roads, bridges, ports, and water systems not to mention rail beds, tracks, and rolling stock are in urgent need of upgrading or replacement. Pat Choate and Susan Walter have completed a survey of urgent infrastructure investment needs totalling over $3 trillion for the 1980s and 1990s.[5] Countries such as France and Japan have used public investment in profitable high speed rail transportation as a spur to new industrial innovation and exports, in addition to their direct beneficial impact on improved domestic transportation.

Finally, it must be recognized that the greatest single determinant of business investment in new productive plant and equipment is not special tax gimmicks but rather steady growth of demand and avoidance of recessions. Moving our economy toward full employment is the single most important contribution we can make toward strengthening industry and improving productivity growth.

Equity and Efficiency: A Full Employment Society

Conservative and supply-side economists often contend that equity and efficiency are incompatible goals for our economy. In the 1980s, it is far more important to understand that efficiency may be unobtainable without equity, and that equity and efficiency goals must be merged to achieve a more successful economy and a more humane society.

A full employment society best represents the practical unity of equity and efficiency. Full employment is the most efficient route toward increased productivity and reduced inflation. Full employment also means that every American able and willing to work can enjoy the dignity of a decent job. In achieving full employment, groups that are hard to employ in times of recessions or high unemployment can be brought into the working economy and given the dignity that only a job can provide in our modern society. Full employment thus means full employment for all groups of our citizens, as well as our full industrial potential.

Achieving and maintaining full employment also provides the most "efficient" solution to the problems of poverty, welfare, crime, deteriorating urban tax bases, and declining educational achievement.

The overall framework of economic policy needs to be complemented by an active employment and training policy to prepare our workers and potential workers for the jobs of today and tomorrow. While the Administration and Congress have concentrated on improving the physical side of the production process--with tax rewards for new plant and equipment and research and development--they have simultaneously turned away from a commitment to the human side of the production process: the workers and skills necessary for productivity and economic growth. The Federal employment and training system has worked reasonably well, despite numerous problems that any new program is likely to have. We should concentrate on solving the problems rather than a mistaken argument that the programs do not work. Undermining our country's investment in people, or human capital, directly contradicts this Administration's massive financial incentives for investment in physical capital and undermines prospects for any progress toward improving ultimate productivity, the stated target of the Administration's massive tax cuts. A sensible economic policy must reverse Reaganomics' destruction of productivity-enhancing programs for education, children, and childhood nutrition, and skill training. America's historical commitment to a strong educational system must be renewed, not abandoned. And our employment and training programs need to be improved and expanded, not wiped out in this time of deep recession and rapid economic change. Investment in "human capital" is all the more important as our economy becomes ever more technology-intensive and complex.

In the interest of both efficiency and equity, the programs that protect workers from the adverse consequences of economic dislocation should be strengthened, not weakened, for the 1980s. Workers who lose their jobs need the protection of unemployment insurance and other adjustment assistance in order to make a transition into appropriate new jobs where their skills and experience can be utilized and developed--and not lost to society and the worker. Plant closings should be a stimulus for retraining and mobility programs common in Europe that allow displaced workers to upgrade their skills and move into new productive lines of employment.

Taken together, these investments in our children and in our workers can be seen as the third available means of reviving productivity growth. In the context of stable macro policies (including low interest rates) geared to reaching full employment, productivity will be strengthened by substituting consciously considered, coherent industrial policies in place of today's accidental and incoherent industrial policies, by undertaking needed public investment in infrastructure and by recognizing the necessity of strong public investment in the people who make up our country and our workforce.

The need for a decisive change of course could not be more urgent than at a time when record millions of people are out of work and a consistently optimistic Administration itself predicts unemployment continuing above 9 percent. We are well down the course described some months ago by Herbert Stein, chair of the President's Council of Economic Advisors under Richard Nixon: "If the captain of the ship sets out from New York harbor with a plan of sailing north to Miami, 'Steady as you go' will not be a sustainable policy, and that will be clear before the icebergs are sighted." As many had predicted when the compass settings of Reaganomics were first announced, the icebergs are now around us, with a vengeance. While many admire the President's ability to sell his programs to a disorganized Congress and American public, excellence in the pursuit of error is hardly a commendable virtue.

I feel the full employment alternative to Reaganomics outlined in this paper provides a much more solid and credible foundation for economic recovery.

The proposed combination of coordinated general economic policies, targeted anti-inflation policies, consensus building mechanisms, industrial policy, and active employment, education and training policies represents the most direct path to a full employment society. It is a path that this country must take.

One of the best investments a society can make is in its people--to allow its citizens to develop in accordance with their abilities and interests. This is the essence of the freedom we desire.

The national government cannot emphasize certain kinds of freedoms and forget others. Free markets reward those who have market power, but they do not improve opportunities for those who have little wealth or income. Creating the conditions for equal opportunity must therefore be a major responsiblity of government. The federal government has increased freedom from want, from discrimination, from poor housing, from tyranny, from ignorance and from economic exploitation. Freedom is indivisible. We cannot emphasize only those forms of freedom that benefit mainly the powerful.

[1] See Charles Schultz, "Long Term Budget Strategies in J. Pechman, ed., _Setting National Priorities_, Washington, D.C.: Brookings, 1982, pp. 187-220.

[2] See Robert J. Barro, "Unanticipated Money, Output and Price Level in the United States," _Journal of Political Economy_ 86 (1978), pp. 549-80.

[3] Don Nichols, _A Strategy for Monetary Policy_, Testimony before the Joint Economic Committee, June 2, 1982.

[4] Ibid.

[5] Pat Choate and Susan Walter, _America in Ruins_, Council of State Planning Agencies, 1982.

Representative REUSS. Thank you, Mr. Marshall.
Mr. Wirtz.

STATEMENT OF WILLARD WIRTZ, CHAIRMAN OF THE BOARD, NATIONAL INSTITUTE FOR WORK AND LEARNING, WASHINGTON, D.C.

Mr. WIRTZ. A personal note first, Mr. Chairman. I submit, quite respectfully, that I was totally taken aback by your introduction of such a strongly partisan note into this debate right at the outset of the hearings. Mrs. Wirtz is here. Her home is St. Louis, and I dedicate my remarks to the St. Louis Cardinals. [Laughter.]

Representative REUSS. Let's dedicate them to beer, and we've got everybody. [Laughter.]

Mr. WIRTZ. I guess four economists and one lawyer is about an equal deal.

I have only a few "minumental" footnotes to add to these macroeconomic comments, some of which I don't understand, but I am so impressed when four economists agree on everything, that I am willing to take all of it for granted, and only to add a few little, much smaller notes on my part, to summarize very briefly what's in the longer paper.

You asked first for an assessment of the overall economic condition. Responding in terms of the announcement last week of a 10.1-percent unemployment rate, I can only say to you that from everything I know that figure grossly understates the situation.

When you mention the prospect of the committee submitting a program for the Congress' broader consideration I hope, first, that there is included in it a suggestion that we develop some better measurements of this situation. Congressman Hawkins and I were talking a little informally before the hearing. We were thinking back to some 14 years ago, when we were trying to develop a "hardship" index. There's been great progress in that, and there are now two quite responsible developments of what is called, I think, most generally, an employment-related hardship index.

One of those is by the Center for Social Policy Studies at George Washington University, the other, by MDC, Inc., in Chapel Hill, N.C., working in cooperation with the Research Triangle. What is being done is to take the unemployment figures, the poverty figures and other indexes, and bring them together to try to develop whatever may be the human implications of what we're talking about.

I don't know how much effectiveness there is in any statistics in this particular area. I don't know whether the 100 million decisionmakers in this country make up their minds on the basis of a statistical index. Yet we ought to have the best possible index we can. If we bring together the figures on poverty and the figures on employment, tie in the relationship between them, as these new studies are doing, we get some very interesting results.

As nearly as I can read these hardship index figures, if you take into account multiple earning wage earners in a particular family and all of these other things, the number of workers in families whose earnings won't pay the bills now is about twice the number suggested by the unemployment statistics themselves.

If you go on and look at the situation a little further, adding in the members of the family, there are between 25 and 30 million people in this country—members of families in which one or more persons is working or trying to work—who are seriously adversely affected by the current unemployment situation. That is about 1 out of 7. You get some very interesting figures when you move beyond the mechanics or beyond the sterility of these traditional economic indicators and try to figure out what they mean in terms of people's lives.

There is another difficulty about the traditional index. Because it doesn't tell us anything about the causes of unemployment, it in itself suggests nothing about the cures. More specifically, it doesn't break down at all the difference between what the economists identify as cyclical unemployment on the one hand and structural unemployment on the other. This country is hurt seriously today by the prevalent assumption that unemployment is essentially a matter of ups and downs and will respond quickly to whatever is done, as far as the economy as a whole is concerned.

Two of my colleagues have already made this point, so there is no reason to develop it more fully. I believe it was Professor Eisner who mentioned what is suggested here as the likelihood that if we should get economic recovery in this country by every other measure, the unemployment rate would probably still be between 6 and 8 million people.

I hesitate to mention this, because of the possibility that somebody is going to misuse it, to say we can't get below a 6- or 8-percent level. I have been testifying before this committee for almost 20 years now, and my position has been every single time, as it is today, that the only decent definition of full employment is someplace between 3 and 4 percent. We can't get below that, because there are people moving in and out of jobs. But it is time for somebody to start talking about full employment again. It is a realistic goal, yet it is going to require to reach it, putting employment in the first place, instead of someplace else on down the line.

The committee has also asked for comments on particular possible constructive measures that can be taken, and really my colleagues have mentioned almost all of those which I have in mind, so I refer to only one or two. I think the Job Training Partnership Act which has just been passed is a good act. It is a training act, and it leaves out jobs entirely. The attempt in the last few days to suggest to the country that this administration has passed a jobs act just isn't right. What has happened, of course, is that as far as the public employment bill is concerned, this Senate has, in effect, rejected what the House did as far as that employment bill is concerned.

I can't understand how in any circumstances there will be a decision made what would be about 200,000 or 250,000 jobs to the people who need them most, doing things which the country needs badly. I can only interpret the rejection of that bill as a decision that it is perfectly all right to place the burden of removing inflation on those who are least in a position to support it or to carry it.

As far as the temporary measures are concerned, I would suggest only one thing that hasn't been mentioned here. The unemployment insurance program is seriously in need of attention. It is really a kind of sad commentary on our creativity that all we do about unemployment insurance legislation is wait until we are in the middle of a depression which we knew was coming, and then get into a debate about whether to extend the benefits or not. And we don't do anything about the structure of that program.

NEED ELEMENT IN UNEMPLOYMENT INSURANCE PROGRAM FOR RETRAINING

Quite simply, I think there ought to be added a program, as a substantial element in the insurance program, which makes it a retraining program. We are spending about $23 billion this year on unemployment insurance benefits that will go to about 10 million people. It is just protection. Most of it is not being used to support a retraining or job placement program.

There are some exciting things going on around the country, all of them involving cooperation between employers and unions and the educational authorities. And without taking more time to develop the point, I would hope very much, Mr. Chairman, that consideration is given to making the unemployment insurance program in this country a constructive as well as a protective program.

Moving on to the longer range aspects of this matter, I am not a good witness. When the talk is about monetarism, and so forth, I'm lost. You will get better counsel than mine. I don't mean to duck the point. It seems to me we are in trouble in this country because we are spending far, far too much money on suicidal munitions, and not passing the bill for it on to the taxpayer. My reaction is quite simple. It is that a very large amount of the military budget, including particularly what is going into nuclear weapons, ought to be diverted through public and private channels to making things which people in this country need and which they can use, instead of making things that threaten to blow up the rest of the world. If that were done, employment would go up and inflation would go down. I know those are oversimplifications.

You do include in your letter of invitation, and you, Mr. Chairman, referred in your introductory remarks to investments in education, training, infrastructure, research and development and that's really the only point on your agenda to which I can speak with any particular competence.

Professor Eisner has already referred to the importance of human capital theory and to the development of the human resource. In your point No. 1, Mr. Chairman, you identified the importance of the infrastructure, in terms of physical assets of one kind or another. I know from all you have done that you would count the development of the human infrastructure equally important. Instead of talking, under the circumstances, about the nuances or intricacies of human capital theory, let me suggest just four little items which will illustrate other much more important things which it seems to me we ought to be doing.

There is pending before the Congress what is called, I think, the American Defense Education Act, appearing under the sponsorship of Congressman Perkins and Senator Pell. It is modeled on the National Defense Education Act of 1958. It is directed particularly toward the very significant current and prospective shortage in this country of scientists, engineers, and technicians. There are a lot of jobs in those particular areas which it is very important that we fill. I would suggest the country's serious consideration, paralleling its response to Sputnik, however many years ago that was, of an identification of all of the needs which are going to develop as we move into an information society and the taking, then, of whatever steps are necessary at the Federal, State, and local levels to gear educational training to the meeting of a lot of needs which only the futurists are talking about now.

A second point, along a somewhat similar line, involves the whole matter of adult education. With the economy changing as rapidly as it it now, as the content of work shifts as markedly and rapidly as it is, we are going to have to recognize that a substantial part of formal education should be made available to people after they become adults. It seems to be critically important that we develop continuing education.

In an only slightly connected line, I expect it won't be long before this country is giving serious consideration to the European experiments with the introduction of sabbaticals into other than the educational occupation. If employees were to have an opportunity to renew themselves, retrain themselves at recurrent intervals, it would have a variety of important effects.

And of a seemingly almost entirely different dimension, I believe it is only a matter of time until we seriously consider a Youth Service Act in this country. A great deal of our unemployment is concentrated among youth. The phrase "national service" has accumulated so many barnacles that I'm not suggesting that. I'm suggesting a local community-based service program, which would mean the introduction that can possibly be done. It's a matter not of constricting opportunity, which, it seems to me, would be a very important element, as far as they are concerned and as far as the community is concerned.

Just a word, perhaps personal, on behalf of Professor Galbraith's 74th and myself—I think we are going to have to rethink the whole subject of the uses of the last chapters of people's lives. People are simply not going to settle for security as life's door prize. Furthermore, I doubt whether the ultimate answer is to extend the right to continue in a job which the individual had previously held. I think we're going to find tremendous opportunities for older people, seniors, to make contributions to their community.

I close with just two notes. First, it is critically important that when we are talking about employment, we keep in mind one simple fact, and that is that there is much more in this country that needs doing that can possibly be done. It's a matter not of constricting opportunity, but of a little architectural engineering, systems engineering initiative, as far as the leadership is concerned.

Then one perhaps overly personal note in conclusion. It comes from having looked back in preparation for this testimony to a hearing which was held before this committee in February 1968. The subject then, too, was unemployment. This committee was very critical of what it considered the inadequate efforts being made by the administration to do something about the unemployment. There was talk, particularly, about the concentration of unemployment among minority groups, the economically disadvantaged, the handicapped, and the teenagers. The witnesses that day in no way went on the defensive, but welcomed the sharpest criticism from this committee.

You know my only point in telling this story: that the unemployment rate in this country then was 3.5 percent. You begin to wonder whether our most serious problems lie less in whatever policies are being advocated at the moment than in some loss temporarily of our sense of national purpose and our realization of our infinite potential.

I don't see any less reason for fighting for 3½ or 4 percent unemployment today than there was 14 years ago. If you should call up the Secretary of Labor to speak to the subject, I hope you will give him as hard a time as you did one of his predecessors.

[The prepared statement of Mr. Wirtz follows:]

PREPARED STATEMENT OF WILLARD WIRTZ

With so much being said every day now about unemployment, but with almost all of it keyed to votes rather than jobs, it is hard to know where to pick up in addressing this Committee's serious concern. So these remarks will be brief, leaving as much time as possible for whatever more specific inquiry you may consider worthwhile.

Your first request is for my "assessment of the overall economic situation." Responding in the context of last week's announcement of a 10.1 percent unemployment rate, I find it substantially more serious than this statistic indicates. The unemployment index has two weaknesses, particularly so far as providing the public with adequate information is concerned.

First, it doesn't tell the story in terms enough people understand, which means human terms, and its real meaning is being deliberately covered up. The idea is encouraged that with more than one wage earner in many families, and with various shock absorbers having been built into the system, being out of work doesn't hurt as much as it used to.

I assume the Committee is following the evidence which is now emerging from two highly responsible developments of what is being called an "employment related hardship index." The work on this index is being done by the Center for Social Policy Studies of The George Washington University and MDC, Inc., at Chapel Hill, North Carolina, in collaboration with the

Research Triangle Institute and with the support of the Charles Stewart Mott Foundation and the Rockefeller Brothers Fund.

This hardship index is designed to supplement the economic indicator unemployment figures with information regarding the affected individuals' personal and family situations. It makes adjustments for a number of different factors: multiple wage earners, part-time workers, discouraged workers, unemployment insurance and welfare payments, and so forth.

Although under-funding limits both the comprehensiveness and the currency of this critical hardship supplement to the traditional unemployment index, a substantial body of reliable evidence has already emerged. At some risk of oversimplification, it indicates:

> * That even when multiple wage earners in the family are taken into account, the number of workers in families whose earnings aren't enough to pay the bills is about twice the number reported as "unemployed"; and
>
> * That even after all earning supplements are taken into account -- income from savings, from government support programs, and all -- the number of workers left at below-poverty levels is substantially larger than the unemployment figures themselves indicate.

These computations invite as many arguments as they resolve, perhaps more -- especially about what earnings and income levels are to be considered adequate. Yet as fairly as I can evaluate them, they indicate that between 25 and 30 million people in this country -- members of families in which one or more individuals are working or looking for work and unable to find it -- are adversely and seriously affected by the current unemployment situation.

I don't know how important any statistical index is in stimulating action by the country's hundred million decision-makers. But it is imperative that this unemployment picture be described in terms people understand. I respectfully urge the Joint Committee's encouragement of the fuller development of this supplementary employment-related hardship index.

The other weakness in the traditional unemployment index is that it shows nothing about the causes of unemployment and therefore nothing about what will be required to cure it. The prevailing assumption is that unemployment in this country is essentially "cyclical" -- a matter of ups and downs, responsive to general economic conditions. The country was told again night before last that if the 11 million people who are out of work will just wait until some other things are taken care of there will be jobs for them.

Will there be? One of the critical questions, which pitifully few political leaders of whatever persuasion appear willing to face, is how much employment is now being built in (so that it is "structural" rather than "cyclical") to our assumptions about the future. A good deal more, I'm afraid, than any except a few people realize.

This is essentially the question of the effects of advancing technology, and of broader changes in the nature of work, on the need for the human membership of the work force. Studying this question carefully in the 1960s, we concluded, rightly I think, that new machines were creating more jobs than they were destroying. I think this was also clearly true during at least the earlier 1970s. It is not at all clear that it is true today. At the risk of irresponsibility, for no reliable analysis of this development is available, and only to emphasize the importance of the point: my best guess is that what would now be considered economic recovery by all other measures would leave an unemployment rate of between five and seven percent, which means 6 to 8 million people.

I don't need to add that in my judgment "full employment" still means, as it did when I was testifying before this Committee 10 and 15 and almost 20 years ago, no more than something like 3 or 4 percent unemployment -- the inevitable "frictional" factor, people entering the work force and moving from one job to another. This still seems to me a totally realistic goal. But it is going to require putting full employment in the first place instead of someplace else on down the line.

Turning now to the Committee's request for comment and suggestion regarding specific action programs: Certain emergency measures have to be taken. Even larger importance attaches to revitalizing the economy.

So far as meeting immediate needs is concerned, I would endorse strongly -- though this is now gratuitous -- the recently adopted Job Training Partnership Act. There is reason for encouragement in governmentally supported job training becoming once more a principal of bipartison policy. Separating the training and income transfer elements makes good sense.

The defeat in the Senate of the minimal public employment bill adopted by the House seems to me, and I believe to most people, simply wrong. To accept and affirm the principle of reducing government expenditures leaves all of the important questions of priorities. Putting 250,000 of the most seriously unemployed workers in this country to doing some things which badly need doing seems to be plain good business. Reversing that decision can only be interpreted as a conclusion that the burden of stopping inflation is to be placed on those who are suffering from it most seriously.

More attention should be given, I suggest, to improving the unemployment compensation program, not just extending its benefits but making it more responsive to present and prospective needs. It is a sad commentary that our creativity is limited to debating on extension of unemployment insurance benefits when we are in the middle of a depression and seriously concerned about whether many of the old jobs will be there when it is over. In fact we know a lot of them won't be.

We ought to be using this down time to permit those who are unemployed, with little prospect of returning to their previous jobs, to upgrade their skills or to develop new ones for which there is larger demand. Instead of this, the present unemployment insurance legislation virtually precludes such re-training.

Serious attention should be paid to what are so far only scattered experiments with constructive, rather than simply protective, measures to meet unemployment. The collective bargaining agreement between Ford, GM, and the United Automobile Workers offers an example. Governor Dupont is developing in Delaware a constructive linkage between the unemployment insurance, employment service, and educational systems, to set up training programs for unemployed and probably displaced workers. In several of the southeastern states, perhaps particularly South Carolina, closer working relationships between employers, vocational education offices, and community colleges are resulting in substantial reductions in the waste of re-training opportunities.

We manage the unemployment aspects of recessions very poorly in this country. Compensation isn't enough. These ought to be times for re-training and for renewal.

So far as longer range economic policies are concerned, my qualifications are so limited regarding most of them that I can add nothing to the Committee's deliberations. This isn't to duck what is obviously most important. It seems to me plain, personally, that part of the answer to inflation is to reduce government expenditures; and that the way to do this is by taking the action which will permit curtailing sharply the budget for suicidal munitions, particularly and specifically nuclear weapons. Redirecting those expenditures to domestic enterprise, through private as well as public channels, would increase employment and would curtail inflation. Yet I recognize that these are oversimplifications involving issues on which the Committee will be taking more competent counsel.

You refer in your invitation, however, to "investments in education, training, infrastructure, research and development." This has been the subject of a good deal of my personal experience, and it seems to me an area in which those of otherwise conflicting economic persuasions, including "supply-side economics," should find broad common ground.

The one limitless resource this country possesses lies in the development of people's talents. Yet instead of attempting here to get into the intricacies of "human capital theory," let me suggest several specific programs which seem to me to warrant much more consideration than they have received so far. They are selected from a number of other possibilities to illustrate different aspects of the potential. Listing them in summary form will permit your questioning in whatever detail may seem worthwhile.

Both houses of the Congress have before them, with the sponsorship of Senator Pell, Congressman Perkins, and others, proposals for an American

Defense Education Act, patterned to some extent on the National Defense Education Act of 1958. This legislation is directed most specifically at meeting the present and prospective serious shortage of engineers, scientists, and technicians. I would urge serious consideration of an even broader approach which would start from the clearest possible identification of the educational and training needs which the advent of an "information society" will magnify, and then make arrangements for whatever combination of local, state, and federal forces will lead to better meeting those needs.

One of the most encouraging developments in contemporary education involves the large scale extension of the educational opportunity to adults. A great deal more can and should be done along this line. Sooner or later consideration will be given in this country to some form of extension of the "sabbatical" concept to other occupations than teaching.

The concentration of so much current unemployment among young people in this country is bound to lead eventually to fuller consideration of a youth service program. The "National Service" phrase has accumulated some unfortunate and unnecessary barnacles. There are a variety of ways of using a local community base to build a one-or-two year service component into young people's preparatory experience.

We are going to have to re-think completely the uses and the usefulness of the last chapters of people's lives. "Security" isn't enough. Extending the right to go on working at whatever was being done before probably isn't the ultimate answer. There are potentials of infinite magnitude here.

These may appear, in such brief reference to them, entirely disparate suggestions. Yet they illustrate, however inadequately, the underdevelopment so far of the human resource. Add the fact that with all of the statistics about unemployment and with proper concern about its impact, there clearly remain an infinite number of things which need to be done in this country and in the world. It isn't a matter of constricting opportunity, but of whether we have what it takes to maintain the authentic American sense of purpose.

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One perhaps overly personal note in conclusion comes from having looked back to the record of hearings which the Joint Committee held in February, 1968. The subject was unemployment. The Committee was critical of what it considered the inadequate efforts being made by the administration to meet certain aspects of the situation, particularly the concentration of unemployment among minority groups, the economically disadvantaged, the handicapped, and teen-agers. The witnesses that day, in no way defensive, welcomed the Committee's criticisms and suggestions.

You know the only point in making this reference. The unemployment rate for January, 1968, which had just been announced, was 3.5%. You wonder whether our most serious problem today is less in any particular policies than in our having mislaid -- temporarily -- our sense of national purpose and of our limitless potential.

Representative REUSS. Thank you, Mr. Wirtz.

And thank you all for some fine, stimulating and heart-warming testimony.

As I said earlier, the Democratic leadership of the House and Senate has requested us, of the Joint Economic Committee, to be preparing policy recommendations for the lameduck session that starts on November 29. I personally welcome that assignment, because if we don't do something in that month-long session, what with the time that is consumed in organizing a new Congress, we may not be able to approach a first-phase emergency program for many, many months of 1983—and I don't believe we can or should wait, drawing on the reports of the Joint Economic Committee of the last couple of years and personal conversations with the members who have participated in those reports, and having in mind the fact that the lameduck session is necessarily limited in time, and less in scope. And we shouldn't try to do everything.

LAMEDUCK SESSION AGENDA

I have thrown on the table this morning a first—rough draft of what might be done. And I will repeat it very briefly, and then ask you whether you think that's the right way to go, whether you think any of the four proposals are misguided and whether you think, given the constraints of the lameduck session timing, there should be anything added to it.

So, the proposed package is:

One, a program to stimulate investment in infrastructure—put, in some appropriate financial way, some of the 11 million unemployed to work preparing and building the streets, bridges, water systems, ports, and other public facilities which are now in a desperate state of disrepair.

Two, housing: The housing outlook continues to be bleak at a time when there's a tremendous need for housing. And the suggestion there is that, by some cost-effective subsidy, moderate-priced housing be brought within the reach of the millions who need it.

Three, jobs programs: This has been much referred to, but there does, in my judgment, need to be on the books an immediate public employment program—and if we went back 50 years to F.D.R.'s CCC, we could do worse—which will grapple with the immediate, appalling social problem in our cities and areas of rural poverty.

And fourth and last, some expression from Congress on monetary policy. There the leadership in both the Senate and the House, with widespread Democratic support, have put in bills that would, in a nutshell, ask the Federal Reserve to get off its monolithic monetarist kick and also take into account interest rates. If they would do that, then there would be a good chance of a healthy prolongation of the election-month burst of monetary activity which we are now seeing in the Federal Reserve.

As many have forgotten, the Federal Reserve, egged on by the administration, is still proudly boasting that right after the elections, starting January 1, they are going to forget all about the 16 percent M_1 ebullient growth, that was too much of a good thing which they have been achieving in recent weeks, and go back to a 4-percent monetary target.

I believe the passage of some such legislation as I have just referred to would signal to the Fed that they should not do that, they should not bring the high-interest-rate regime which, coupled with the administration's feckless deficit policy, has brought about our deep recession and thrown the world in a turmoil.

Well, that's the four-point, quick program which I have put on the table.

Now, let me ask, members of the panel, whether any of you disagrees with any of those four points, whether any of you would formulate them in any different way, and whether you think there are other short term, immediately achievable objectives which ought to lead to a more expansive lameduck session program?

I'll just go across the panel.

Mr. Eisner.

Mr. **Eisner.** I think, Mr. Chairman, the four points are excellent. I would comment briefly on a couple of them.

On housing, the Chairman-designate of the Council of Economic Advisers, Martin Feldstein, has been on record in many of his writings as suggesting that tax incentives or the tax structure has been overly favorable to housing, as compared to business investment, a position which I don't think, policywise, is sound.

It's true the middle classes, upper classes have had substantial benefits in terms of tax treatment. I think the remedy is not to take those away from them, in view of the tremendous slack in the housing industry, and need for housing, but rather to add something for the poor. I have in mind in particular efforts to subsidize ownership of housing by the poor. I think we've had rather unfortunate examples. I know Cabrini-Green and much of the low-rent housing in the city of Chicago have all kinds of problems—I won't dwell on it. It would be very important to have subsidies for poor people to own homes, to own housing units so they will have an interest in preserving and investing in and maintaining them. It will aid a great deal to unmeasured income and welfare.

On the jobs program, I would suggest that jobs programs by Government will certainly be very important. But I would like to see, in addition—and I think perhaps one could get some bipartisan support of this—major efforts to subsidize employment of the hard to employ of the unemployed in the private sector. We have all to easily given up or been very sparse in efforts to have incentives for employment. It's very easy to give incentives for business investment, which I think are unwarranted. Businesses would invest in themselves adequately if left to themselves. But I would pick up on Mr. Wirtz' remarks—it's really a scandal to spend $23 billion or more a year on unemployment insurance. We, indeed, should be spending more, given the amount of unemployment—but not just leaving people idle, without an effort to offer firms incentives to hire the unemployed, without an integrated effort to retrain and give them work.

On monetary policy, I would emphasize again now, as several of my colleagues have, the tremendous importance of real interest rates. We must not quickly take comfort in the fact that nominal interest rates have gone down.

To the extent they have gone down belatedly, because of decline in expected inflation, that is not, in itself, going to help the economy. It's simply going to mean we won't be that much worse off. You have to get the difference between the nominal rate of interest and expected inflation down. And there's a long way to go in the Federal Reserve policy in that direction.

And it's up to the Congress—it's up to the administration to begin with, but the Congress has some responsibility for having asked the Fed at one point to report monetary targets. You should go much beyond that and ask them to follow a policy that will keep the economy moving.

Representative **Reuss**. Yes; as you say on housing, that particular portion of your response, a few quick strokes of the pen could do a lot of good.

For example, I'm not saying this is necessarily the way to do it, but right now, if you take a 30-year-old structure and develop it for an office building or for shops, you get a very nice 15-percent tax credit, which induces you to do it. If you take a 40-year-old building, you get a 20-percent tax credit, but you don't get it if you develop it for low-moderate-income housing.

So, a quick stroke of the pen, by adding low-modest-income residential, could give a tremendous incentive to people in cities, towns, and even countryside to take an older structure and develop it into decent housing.

So, I welcome your suggestion.

Mr. Galbraith.

Mr. **Galbraith**. Mr. Chairman, I would only add my support to all four items.

I'm led to make one suggestion that will be part of the debate on them. We must admit that the administration has had a certain measure of success—and that is in creating the impression that public activities on behalf of the economy and on behalf of the compassionate services of the Government are somehow an exercise in bumbling incompetence. By iteration and reiteration, that impression has somehow been established, and it has even penetrated into the convictions of people who should know better.

We must begin now to counter that particular bit of nonsense to remind ourselves that we have had and have in the United States an extraordinarily good civil service, people of very high quality and motivation. We haven't solved the problems of vast organization either in the public or in the private sector. We have the problems of the vast bureaucratic governmental organization still unsolved as well as those of our great private organizations.

These are part of the problems of the age of organization with which we have still to contend.

But I would hope that we would remind ourselves, as part of the effort that is reflected in these four proposals, that the public service in the United States is a prideful thing, one in which we should have confidence. We shouldn't hesitate over the fact that these measures which you propose, and with which I concur, require administration.

We have, perhaps, been negligent in the past in taking their administration too much for granted; we cannot, in fact, do useful things without it.

We must continue to remind President Reagan, who presumes to be in support of the economic system, that it sure as hell wouldn't have survived this long if the market and the private sector had not been supplemented by the energetic, humane efforts of Government.

While I'm in full flush of oratory, I would like to add my word to what Willard Wirtz—Secretary Wirtz—said, in such admirably blunt language, about the need to transfer resources to purposes such as these from our present, passionate inducement, with the whole idea of blowing up ourselves and the world. He said that with marvelous clarity. And as he said it, I sat here wishing to God that I had said it first. [Laughter.]

Representative REUSS. Mr. Heller.

Mr. HELLER. Mr. Chairman, I don't think you are going to get much disagreement on your four-ply program from this panel, whose spectrum of views runs from A to A-plus——

Mr. GALBRAITH. May I interrupt to remind Professor Heller, it runs from A to A-plus, but there is no legitimate B. [Laughter.]

Mr. HELLER. I accept that intervention and approve of it. Well, I just want to comment a little bit on infrastructure and housing. On infrastructure, I am just delighted to see this panel and the chairman of this committee raise that to the status it deserves. One of the great inconsistencies of so-called supply-side economics espoused by this administration is that it pays no attention whatsoever to the supply-side impact of the spending side of the budget, of the constructive investment that is absolutely necessary as a counterpart to the investment in the private sector that they put all of their exclusive emphasis on. And, of course, the supply siders have preempted a perfectly good classical economic approach—that of beefing up our ability to grow and our ability to produce more—by going to extremes that have earned them the designation, in Martin Feldstein's words of "extremists." I noticed Kevin Phillips calls them the supply-side absurdists. I rather like that. And others call them radicals.

They are neglecting the fundamental supply-side contributions that can be made through public investment. By the way, this committee is probably aware of an excellent article in the October 7 Wall Street Journal, "Crumbling America—Put it in the Budget," by Mr. Hoffman, executive director of the Republican House Wednesday Group. Perhaps there could be a bipartisan consensus on this.

Also, since personal notes have entered here from time to time, I would like to cite an example. We hear so much about these dead-end public jobs. But let me cite an example that the chairman may recall, since he comes from Milwaukee and since I have previously cited it before this committee; namely, my father. He was a civil engineer. He was employed by A. O. Smith in Milwaukee. He was out of a job for 2 or 3 years during the Great Depression.

Apart from the fact that he took differential and integral calculus during that period at the Milwaukee branch of the University of Wisconsin, he was employed under the Federal Emergency Relief Act, the precursor of WPA and the Public Works Act. His job was to help design an addition to the famous Milwaukee sewage plant which produces milorganite and which is one of the outstanding plants of its kind in America.

In other words, FERA took men with obvious skills that were going to waste and put them to work on an infrastructure job that needed doing. Federal money brought the two together, and there was nothing but gain, no loss whatsoever.

On housing, just this thought. Yes, we need housing stimulus for the poor—and particularly now that it takes some 40 percent rather than 20 percent of a family's median income to finance acquisition of a house—but we should couple it with a reduction of the mortgage interest deduction under the income tax. I see no reason why I should get a reduction for either the property taxes or the mortgage interest payments on a cottage or a second home. Now I know that cuts many Members of Congress to the quick, because they have to maintain two homes, but there ought to be some kind of a limit, perhaps a dollar limit, in terms either of the value of the home or the amount of the deduction.

And that alone could raise many millions of dollars and could help finance the positive program for the lower income groups, the people who cannot afford a decent house or decent housing. And I believe there we could do a redistributive job that would improve the whole housing structure.

Representative REUSS. Thank you. Mr. Marshall.

Mr. MARSHALL. Mr. Chairman, I think your list is a very good one, and therefore, endorse it.

Let me make some observations about it, particularly the jobs part. I had thought much about how to make the jobs program work. One of the perplexing things to me these days, in the light of numerous detailed and sophisticated evaluations showing that the programs were a good investment for the country, is the pervasive idea in the Congress, the media, and among the public that the programs didn't work.

And I think it relates partly to Professor Galbraith's point about the idea that all public programs have not worked. I think it's particularly true with respect to the jobs program. There's no evidence for that. Experts from across the political spectrum have evaluated these programs, some expecting to find that they were worse than they were and have all found what you would expect, that these were good investments. They were cost-effective, some more than others, but they did the most for those who needed it most, and not as is the case with so many other public programs, the most for those who needed it least.

If the committee could do anything to counter that impression with the facts, maybe take a look yourselves at all these evaluations, synthesize them and put the record straight about the accomplishments of employment and training programs that would serve a useful function.

There is no doubt in my mind that we have learned from these programs and were in the process of improving them. The Job Corps, for example, is a much better program today than it was when it started, partly because we learned, and we learned a lot about other programs and kinds of things to do, and therefore, ought to try to get that message across to the people.

One of the basic problems is that many people don't look at these programs as investments. They look at them as all costs. In fact, even some of the evaluations of the jobs programs tend to count the output of those jobs as zero. That is ridiculous, when you look at the wide range of things that the people were involved in, going back to the CCC programs, the WPA and on into public service employment programs more recently. And they have made a tremendous contribution to the country. And I think that investment attitude about the jobs program might be able to overcome some of the negativism about them.

With respect to your comments about monetarism, what I think needs to be done is to go far beyond that. I think that until we take a look at the machinery for economic policymaking in the country and the problems caused by the structure of it, we are going to have great difficulty pursuing a consistent course. It would be a stop-and-go and short run, like many of our private decisionmaking processes, which are driven too much by short-run profit maximizing to the detriment of long-run viability.

Now I think we've got the same kinds of problems in the economic policymaking in the country, and I don't think it's going to come from any place other than the Congress, because you are responsible for the economic policy of the country. And I don't think that you ought to dance to the Federal Reserve's tune or that the White House ought to dance to it either. I think there is something to be said for relative independence of the Federal Reserve, but not dominance of policy, and having the economy in a condition that it is now, simply because of a misguided theory; they admitted when they adopted at that they didn't have the vaguest idea whether it would work or not. And those kinds of decisions seem to me to require debate before they are made. It would be much better to agree on the desired outcomes of the economy, and then have the Federal Reserve adjust its policy to achieve those outcomes, rather than the reverse.

But I think that that is going to require more than simply telling them to abandon monetarism.

Representative REUSS. Thank you. Mr. Wirtz.

Mr. WIRTZ. Just two points, and very brief.

The first one has really already been made. The public employment bill came up, was passed in the House, rejected in the Senate. I would agree with what has been said, that there are probably more attractive ways of packaging that program. It would be possible to add both local community and private sector elements to that bill, which I think would make it much more attractive.

My other point is simply that I would hope that a program of the kind you are developing would include some recognition or some reflection of what I think is the importance of education in any program of this kind. It can be fitted in any of several places here, but I really believe it is one of the important long-range recovery revitalization elements. But in short, I subscribe completely to the proposal.

Representative REUSS. Thank you.

I now recognize our new and distinguished member of the committee, Congressman Gus Hawkins, author, among many other things, of the Humphrey-Hawkins bill. Never has so good a piece of legislation been ignored by so many for so long.

Representative HAWKINS. Thank you, Mr. Chairman.

May I first express my appreciation to many of the witnesses today who, I think, over a long period of time have helped us in the drafting and eventual passage of the Full Employment and Balance of Growth Act of 1978. I think the contribution made by many of these witnesses certainly was responsible for the success which we had in the passage of that act; however, I think they will reflect on the manner in which we have reacted once the act was passed. If there is any bipartisan aspect to it, I think many of them will recognize that we, too, were critical of President Carter in 1980, in particular, because we felt that he did not support the provisions of the act. And I personally believe that some of his difficulties, political difficulties, were due to the fact that there were many of us critical of President Carter at that time.

So I think that it gives greater weight to what we say now in being critical of the current administration. I think the witnesses have done an excellent job; however, I feel that in their restraint, they have not brought out some of the things that some of us who don't have professional credibility to protect would say, even though it may be classified as politics—I would say that I think we are being very kind to the administration. I think the witnesses have been overly kind in showing the restraint that they did. If there is anything, it seems to me, that comes out of this hearing, it is that we are in deep trouble, that this trouble is directly traceable to the current administration, that to heap the blame on previous administrations is of no consequence at this time. Mr. Carter is not seeking any reelection. So the solution is not to vote against Mr. Carter. That would be very ideal.

We can only confront conditions as they do exist at this time. Certainly, Mr. Reagan knew when he became President of the difficulties of overcoming what he claims to be some of the things which he inherited, yet very loud in the statements made about what he proposed.

I think gleaning from what the witnesses have said that we are in deep trouble because this recession is not over. We are facing another one which will come out of this current one, and at the same time, we will not have the protective safeguards that we had, because most of them are going to be eliminated.

And I think there has been an assumption made this morning that, in some way, the President, perhaps, is acting out of good motives. I would certainly challenge that to indicate, Mr. Wirtz, as you did, that we can, with some degree of minor changes, make the public works bill more acceptable—I certainly think your suggestion is in good faith—to the administration; to make it more acceptable to the administration I think is really stretching it. Because if we assume that one of the difficulties that we face today is that unemployment is unreasonably high, I think everyone concludes that that is true. And if we relate that to the deliberate policy of the administration, as I think most witnesses did, to the creation of unemployment as a means of solving the problem of inflation, then it's obvious that the conclusion is that if the administration believes that unemployment will solve our problems, then any program to create jobs is antithetical to the objective of the administration.

I think the experience is borne out by the fact that not only did the administration oppose the public service jobs of CETA, not only did the administration bad-mouth CETA as a viable program, and falsify reports and statements in relationship to CETA, so that it was successfully, let us say, destroyed in the public image as a viable program, but he has gone on to do the same thing with every other program. This was not the only program that was opposed by the administration. As a matter of fact, not a single jobs program, I haven't heard anyone credit the administration with supporting a single jobs program. I think it is very significant that these programs should not be destroyed at a time when no substitute is being offered to help the victims of the monetary and fiscal policies that rest upon creating a recession. The WIN program, the Jobs Corps, I think Mr. Marshall referred to that, which the administration says is an excellent program, has been reduced 50 percent. The WIN program is practically destroyed, the senior citizens program under the Older Americans Act has been wiped out. As a matter of fact, the bill was vetoed after Congress approved it. So we are going to be without any of these programs, eventually, when the next recession happens, as I think the evidence indicates that it will come about.

So it just seems to me as what we are witnessing is a very disgraceful and very deceitful expression of public responsibility at a time when such a leadership is certainly needed.

I certainly appreciate the program being offered this morning by the chairman of this committee, Mr. Reuss, but it seems to me that to deal in terms of single programs is, again, going to piecemeal the solution. I don't think there is a shortage. I think Mr. Eisner in his prepared statement dealt with it very beautifully, in which he said we are now being intimidated by disowning programs that have been very successful instead of standing up for them, and being apologetic because the President says you are not offering any new programs. Every time one is offered, as was done this morning, it's opposed by the administration. Certainly, that is accomplishing nothing.

So it just seems to me that we are getting back to the point where we were prior to 1978, when we had most of you as witnesses before the committee, before we acted on the Full Employment and Balanced Growth Act.

And we can't overlook the fact that both Republicans and Democrats supported the act in 1978, its goals and timetables. They thought it was feasible within 4 or 4½ years, we could get unemployment down, we could get inflation down at the same time. The President signed the act, and then from then on, we go off in an opposite direction. Now no one can say it's going to be solved overnight, but we are not even moving in the proper direction at the present time. Instead of reducing unemployment, we are increasing it. I think it has been well said that inflation has seen some slight—that is, the rate of increase has decreased, nobody believes the prices aren't increasing, but this was accomplished again in violation of the act, because a recession was induced in order to accomplish this reduction in the inflation rate of increase. So that was a direct violation of the act.

I would say, before we seem to get into dealing with the individual programs, many of which we already have but are not being used, that what we need to do is get a recommitment to the goals of it, of the Full Employment Act, which is still in the statute books: it has not been repealed. We need a coordinated approach in dealing with policies rather than dealing with them on an ad hoc piecemeal basis. We need to adopt the concept of planning, because without planning for achieving these goals, obviously they are not going to be achieved, and what we need most of all deals with the question of accountability.

There is no penalty for the violation of the act. There is only the question of accountability. We have said, as a people, that we can achieve low unemployment and low inflation at the same time, but we are not attempting to do it, and we are dealing, it seems to me, with piecemeal programs rather than making a definite commitment that we can get unemployment down, and at the same time not create inflation.

Now it is understandable that the current administration has a fear of inducing inflation, but the Full Employment Act said that you deal with inflation by attacking its causes.

I think we have got to admit the administration is not attacking the causes of inflation, but only using unemployment as a means of fighting the inflation. This is pretty obvious. And why this is not said over the media and why this is not picked up and why we will allow an individual to violate an act without calling attention to it—it just does seem to me to be contrary to our democracy and our way of handling things.

Congressman Reuss wanted to deal with some of the questions brought out by some of the witnesses.

I admit I have gone far afield. But it just seems to me—the only point I am making is that, as individuals who are critical of the administration, it seems to me we have got to recommit ourselves to the specific objectives of the Full Employment and Balanced Growth Act, which calls for the reduction of both inflation and unemployment and prohibits the tradeoff.

I just can't, for the life of me, believe that we can make a defense for unemployment, although the President says so.

Now, I think we did talk about the public works bill. But let me quote from Mr. Reagan in October in 1980—that is before he was President. He says:

> The government, with actual needed public works, uses those public works in times of unemployment.
>
> WPA, some people have called it a boondoggle and it was probably one of the social programs that was most practical in those New Deal days.
>
> So, if the government, instead of inventing these new programs, had a backlog of government projects, they would say, "Well, now, this is the time to put those into effect." I think it could be most helpful.

Now, this is what Mr. Reagan said in 1980. It wasn't what he said the night before last. We know what he is engaging in is the technique of the "big lie." And I think we've got to label it as such.

If this was true in 1980, if he felt this in 1980, how can he be so far afield that he can take a little simple bill, such as the public works bill, passed in the House, and oppose it in the Senate, when it called for the expenditure of only $1 billion of money, which was already made available under the budget restraint, and to use it as a time when he must have known that unemployment was going to exceed 10 percent?

It just seems to me to be the height of hypocrisy—anymore than his demonstration of signing the job training bill a few days ago and having behind him some trainees. Where they came from, I don't know. He introduced them as trainees who were going to be helped by the bill that he was going to be signing.

Actually, the bill that he was signing doesn't become effective until October 1983. How can a bill which is going to become effective in

1983 help these exhibits that he had lined up behind him on a bill which he was signing this week?

Now, this, to me, is the depth of lack of credibility of leadership and certainly of good commonsense.

And I just think the witnesses this morning have reinforced the need to move ahead with current policies—with a change in policy.

I think, Mr. Heller, you made a statement here which I wasn't so sure of. I would like, for the sake of the record, to ask you to clarify it.

Your statement—of course, you, first of all, said the U.S. economy has been on a hold for $3\frac{1}{2}$ years. I assume, by that, that you feel that the course has been stayed already for too long a time and we need to get off the course now and change action.

But the statement I was not so sure about—and I want to get some explanation of it—in which you said: "A tradeoff between unemployment and inflation still lives." I wasn't so sure what that meant. I was agonizing over the statement. Perhaps you can put me out of my agony.

Mr. HELLER. I was simply trying to make the point that this administration is using unemployment as its primary—indeed, almost its only weapon against inflation.

And there is no doubt, when you generate 14 percent unemployment—as I say, it's not 10, it's 14—that it tends to reduce demand in the economy, it tends to increase competition of the unemployed for the available jobs. There's no doubt that it has a deflating effect on the wage and price indexes.

When President Reagan claims credit for having reduced inflation, he totally ignores the contributions to the reduction of inflation by good luck on crops, which, after all, is a contribution of nature and God; the reduction of oil prices, which is a result, in very large part, of policies of the Carter administration; and the reduction of housing prices induced by Federal Reserve tight money policies.

The only contribution he's made, really, is by sinking us into an abyss of unemployment, the likes of which we haven't seen since the Great Depression.

By the way, I might note that you are missing, Mr. Chairman, the prime witness who should have been here this morning. If you recall, in signing the Export Trading Company Act of 1982, the President, after opposing it during most of its path through Congress, said it's a great job-creating instrument, one of the main tenents of the President's program.

He went on to say—and I'd like to be sure you get this in the record—"I guarantee you we are going to accept responsibility in this administration for finding jobs for all of the 10.1 percent of the work force without jobs."

You should have had him here this morning to explain exactly how he was going to do that.

Representative HAWKINS. Getting back to the statement, you did not mean the statement taken as support for the trade-off theory?

Mr. HELLER. I think just plain arithmetic tells us that if you have policies that generate unemployment, you are going to have reduction in inflation.

Representative HAWKINS. Let me rephrase the statement—the question.

Would you suggest that there is a better way of reducing inflation than by creating unemployment? And if so, what are some of the other ways?

Mr. HELLER. I think that's been very well covered here this morning.

If we had had a policy—I don't object to a policy of sensible monetary fiscal restraint to curb inflation if it is coupled with a sensible policy of wage-price restraint, if it's coupled with a landing net that hasn't been torn to shreds as has been done in this administration.

I don't see that we can, in the longer run, hold inflation down unless we exercise restraint on all of those fronts: monetary, fiscal, wage, and price. And that is, in essence, what that statement implies.

Representative HAWKINS. The theory behind the Full Employment Act was that we first had to create a healthy economy, without a healthy economy that we could not hope to solve the other problems, that to do so—to create a healthy economy—obviously brought up the question of curbing inflation.

How could you create a healthy economy and at the same time not induce unreasonable inflation?

So, the act attempted to set out at least some of the ways in which to do that. But in doing that, it has also prohibited the tradeoff outright.

The other ways it could be done—obviously, I think many of you have discussed those already today, so I won't belabor that—but I would say if there's anything that has been violated, it is, in fact—I think that's been brought out this morning—that our monetary policy has been too restrictive.

But on the fiscal policy, we have indulged in untargeted budget cuts, even to the extent of cutting those programs that offered very cost-effective results.

Would you, in general, agree with that?

Mr. HELLER. I agree entirely with that.

Of course, what we've done is we've cut taxes beyond any reasonable or responsible degree, given the tremendous needs of the country.

I think it's often forgotten—and particularly by this administration—that we have one of the lowest ratios of public spending and taxes to gross national product of any industrial country in the world.

Japan is 1 or 2 percentage points behind us. They're at about 31 or 32 percent.

But total government in this country—Federal, State, and local—is now 33 percent of the gross national product. And yet, we find that when people deal with the overall levels of government spending, there seems to be an enormous amount of public outcry against it, as against, as I say, in other countries, that a lot of them admire, Germany and others, where public spending is up to 45 percent, 50 percent of GNP.

When it comes to individual programs, of course, they protest.

As you know, there are strong majorities for many of these programs of which you are talking about. It's that old contradiction between our general druthers and our specific beliefs.

So, I would entirely agree that in diverting so much of our resources to the military, in giving absolutely unconscionable tax cuts, in undercutting our public infrastructure, we are running a policy that is both antigrowth and antijobs.

Representative HAWKINS. Mr. Marshall, you, as Secretary of Labor in the years 1979 and 1980—not only those 2 years, but you were those 2 years.

Mr. MARSHALL. The whole time, yes.

Representative HAWKINS. With respect to the Comprehensive Employment and Training Act which the President has labeled to be very wasteful, mismanaged—and its elimination he achieved at the very beginning of his administration—and also without any alternative being worked out, would you agree with this assessment of the Comprehensive Employment and Training Act?

I don't know of any act that has been more bad-mouthed and mispresented than that or one that has been more investigated or scrutinized.

Mr. MARSHALL. That's right.

And you know the results. I've looked at all the investigations that have been done by GAO, by the National Science Foundation, by Brookings, Princeton, the Urban Institute--any number. I've got, probably, 100 pounds of them. And I have yet to find one that said it was not a good investment. We had problems with these programs, but we were trying to work those problems out. And, as you know, we were improving with them.

We started out with the big problem of substitution, but we corrected that in the 1978 Act.

All of the evaluations show that. Not only was it cost-effective for the government, because they got more back than they paid out; this also is the cheapest way to reduce unemployment, and benefited the people who went through the programs, especially for the disadvantaged, the people that we intended the programs to serve.

And that's the reason that I am perplexed by the prevailing attatude that they didn't work.

As you know, they weren't Carter administration programs, but we worked hard to try to make them work. And I think we were evolving them in that direction.

But in my perspective, in order to make such a program work you have to give it greater financial stability than we were giving it with the annual appropriations process.

I'm convinced, therefore, that we will have a public employment program if we ever get to full employment—there's no other way to do it in my judgment; you can do a lot with general programs, but you cannot reach everybody. Public employment programs are good investments; but we ought to learn from our experiences.

As you know, under our youth bill, we built in learning. We didn't call it "Youth Employment Act of 1977"; it was called the Youth Employment and Demonstration Projects Act. And we appear not to want to have learned any of our lessions. But I think one of the main things we need to do is to deal with the question of financial stability in a program that is very complex and needs some time.

In my 4 years as Secretary of Labor, we got our appropriation at the beginning of the fiscal year once, the first year. And it's very difficult to manage a program as complicated as that one was, as CETA was, with that kind of financial instability.

But in spite of all the problems that it had and the exaggerations about the fraud and abuse in the program—the evidence was overwhelming that the programs were successful.

Representative **Hawkins**. What percentage of fraud and abuse would you say was in the program?

Mr. **Marshall**. There was very little fraud. There was some abuse. But I estimated at one point—we had our people take a hard look at it—it was less than 1 percent abuse, which meant that people didn't carry out the letter of the law, which is different from fraud—for instance they didn't keep the records, or didn't provide some information about the eligibility of enrollees.

One of the big problems we had at one time, as you recall, was the loose early administration of the program. We tightened that up in 1978.

Representative **Hawkins**. I don't know of any other agency that has any lower percentage, including the Department of Defense.

Mr. **Marshall**. I had our people take a rough look at it. And the bankers had a lot more problem than we did with fraud in banks than we had in the CETA program.

Representative **Hawkins**. Thank you.

Thank you, Mr. Chairman.

Representative **Reuss**. Thank you.

I just have one brief question.

Mr. Heller called a moment ago for monetary restraint. I certainly think nobody up here or on your panel is advocating emitting jets of printing press money to solve our problems.

Wouldn't you, Mr. Heller, agree that an important part of our anti-inflationary arsenal ought to be some informal system of what has been called—I think by you—credit conservation?

One observes, for instance, that in recent years the businessman who wants to put in a new piece of productive equipment, a family farmer trying to keep the farm together, the homebuilder and homeowner, the auto purchaser, the construction industry have—all have found it impossible to get credit or, if they can get it at all, only at murderously high interest rates.

Meanwhile, the Bunker Hunts have found the banks, fairly slobbering over the chance to earn a high interest rate, grubstaking their silver speculations. And the merger addicts now invest the land—have found it very easy—the other day, for instance, in the Bendix-Martin Marietta case, it turned out that the leading banks were immobilizing $5.6 billion in very scarce credit, keeping it from going through that period to productive uses—to grubstake that merger. Some banks were not just on one side of that piece of cannibalism, but were on two sides. And in some cases, three sides.

Hasn't it been your observation—in that most other civilized western industrial democracies, the government and the central bank use their moral authority and appeal to the patriotism of the major lending institutions to deemphasize destructive speculation loans and thus have more available to lend at lower interest rates to productive loans?

Mr. **Heller**. I would say that civilized financial systems should put an end to corporate cannibalism, that—and I like the way you put it—the central banks should use their moral authority, not put in a rigid structure of credit controls.

A word to the wise from Paul Volcker to the leading bankers of the country could do a great deal. And I believe that kind of guidance would be a good thing.

I suppose it's even more important in times of real credit stringency, which at the moment we don't have in this slack economy. But you are quite right, the spectacle that we have recently seen in the Bendix-Martin Marrietta, et cetera, case is an extreme example of the misuse of credit in the economy.

So, I agree with the general thrust of what you say.

I do find it hard to structure a formal system of credit controls. That is an extremely difficult thing. But the use of moral suasion, moral authority—just as we ought to be doing it in the wage-price field—is part of the broader need to develop some social compacts in this economy.

Representative REUSS. I don't think we need a formal structure. All of this lending is done by the 50 largest banks in the country.

Mr. HELLER. That's right.

Representative REUSS. You've got 12 Federal Reserve banks. That's four banks to a district. They ought to be able to have friendly chats from time to time which would achieve a very wholesome effect.

Mr. HELLER. Friendly chats held in the woodshed.

Representative REUSS. And the discount window and other niceties they have available.

Mr. HELLER. Right.

Representative REUSS. Well, gentlemen, you have made a remarkable contribution.

I think the totality of what you have put on the table here does constitute the constructive Democratic alternative to the administration's policies for which the country is yearning.

I'm going to take the liberty of sending the transcript of this testimony to President Reagan and ask that he tell the Nation what is wrong with it, what he disagrees with and why.

And I think I can say that this request for national major network television time without teleprompters would be seconded by the Democratic leadership. And that would be a very constructive debate.

Representative HAWKINS. Do you plan, Mr. Chairman, to give them equal time in these hearings?

Representative REUSS. We have had abundant testimony from the administration witnesses. And we will again. There certainly will be more than equal time.

And specifically, I hope that within the next few days we can have our friend, Chairman Volcker of the Federal Reserve, up, because the Federal Reserve is a very important part of this.

So, with many thanks for your constructive contribution, we now stand in recess.

[Whereupon, at 12:35 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, October 20, 1982.]

THE UNEMPLOYMENT CRISIS AND POLICIES FOR ECONOMIC RECOVERY

WEDNESDAY, OCTOBER 20, 1982

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss and Mitchell.

Also present: James K. Galbraith, executive director; Louis C. Krauthoff II, assistant director; Charles H. Bradford, assistant director; Betty Maddox, assistant director for administration; and Paul B. Manchester, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. The Joint Economic Committee will be in order for further hearings on the unemployment situation.

In early March the President told us that the economy was "poised for recovery." [1] Three months later he reassured us that economic recovery was "imminent." [2] After another 3 months we were told that "recovery has been sighted." [3] In spite of this, signs of recovery are conspicuous by their absence:

First: The unemployment rate reached 10.1 percent last month.

Second: Industrial production has fallen by 10.8 percent since the President's tax bill was passed by Congress in July 1981, and in September it was at its lowest level since April 1977.

Third: Initial claims for unemployment insurance peaked at 703,000, a record, in the week ending September 18. They remained near this level in the 2 most recent weeks.

Fourth: Capacity utilization in manufacturing fell to 69.1 percent in September, the lowest rate in 7 years.

Fifth: Workers on part time rose by nearly 1 million last month to a record 6.6 million. The number of discouraged workers also reached a record level of 1.6 million last quarter.

Sixth: The index of leading indicators fell by 0.9 percent in August, the most recent month for which data are available.

Seventh: Corporate profits have been decimated by the Reagan recession, falling by more than 25 percent between the first quarter of 1981 and the second quarter of 1982.

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[1] Chicago Tribune, Mar. 4, 1982.
[2] New York Times, June 4, 1982.
[3] New York Times, Sept. 10, 1982.

Eighth: Yesterday the Commerce Department reported that in August, the most recent month for which data are available, total real disposable income fell by 0.3 percent. The economy has been so weak that on a per capita basis real disposable income in August was barely 0.3-percent above the July 1981 level.

Ninth: Retail sales, unadjusted for inflation, rose slightly in September, but are still 1.5-percent below the May level. In real terms the decline has been much greater.

Tenth: Real business capital spending is projected by the Commerce Department to decline by 4.4 percent this year.

Eleventh: We have just learned that according to preliminary data, real GNP in the third quarter increased at a rate of only 0.8 percent, less than half the 2.1 increase for the second quarter. The little increase that there was was largely due to an inventory buildup that was undesired. Final sales actually fell at an annual rate of 0.6 percent.

Since producers didn't anticipate the drop in sales, they produced more than they could sell, which adds to their inventory. This is bad news, for now they will have to reduce their excessive inventories. Thus even if sales turn up in the fourth quarter, output may not, as producers work off their inventory. Real GNP growth, at an abysmal rate of 0.8 percent, corresponds to higher unemployment. Output would have to grow at least three times as fast simply to keep the unemployment rate where it is today.

On July 30 the administration forecast real GNP growth in the last half of 1982 at a 5.3 percent rate. To achieve this we would now need growth at a rate of nearly 10 percent in the fourth quarter, and no one, even in the administration, is predicting this.

The one bit of good news was yesterday's news about housing starts. They were up 14.4 percent in September over August. This is for two reasons: The Federal Reserve, yielding to congressional urgings, has modestly eased credit; and in September the Department of Housing and Urban Development unleashed a flood of subsidies for the new housing construction industry—30,000 units in September alone, treble the amount of the month before, leading some to suggest that if we had elections every month the housing industry would be in much better shape.

The net result of all this is that in the first 6 quarters in office President Reagan has had the worst record of economic growth of any President since the beginning of the collection of quarterly data way back in 1947.

Based on the preliminary estimate of a 0.8 percent change in real GNP for the third quarter, the record shows the following economic growth in the first 6 quarters of recent Presidential terms: President Eisenhower, negative 1.0 percent; President Kennedy, plus 9.2 percent; President Johnson, plus 8.4 percent; President Nixon, plus 0.8 percent; President Ford, plus 3.1 percent; President Carter, plus 8.0 percent; and President Reagan, negative 1.8 percent.

Today we are honored to have with us five leading economic analysts to discuss the current economic situation and outlook. Our witnesses are Francis Bator, professor of political economy, Kennedy School, Harvard University; Raymond Dalio, president, Bridgewater Associates; Michael Evans, president of Evans Economics; Donald Ratajczak, director of Economic Forecasting Project, Georgia State University; and Allen Sinai, senior vice president, Data Resources, Inc.

We are delighted to have these leading analysts of the Nation's economy before us this morning. We appreciate your getting your prepared statements into us in timely fashion. They will be, without objection, received in full into the record.

We will ask each one of you to summarize after our colleague, Congressman Mitchell, makes an opening statement.

Representative MITCHELL. Thank you, Mr. Chairman. I really don't have an opening statement. I merely wanted to inform you that the times are so perilous that I am going into extracurricular activities; I am doing some research that is not really related to my congressional duties.

I am fascinated by the story of the *Titanic*, and I am doing some research to determine whether the captain of the *Titanic* stayed unswervingly on course before the *Titanic* went to the bottom of the ocean, and I will share that research with you. It is a fascinating thing to do every once in a while, to look at those who stay on course despite the icebergs and other perils that are in the way.

I also just wanted to renew my prediction that come the end of February 1983 the unemployment rate will be 11.2 percent unless there is a significant midcourse change. That's inevitable. I've run my data again, and it clearly showed it's 11.2 for the end of February unless the captain of the—well, unless the captain decides to correct and make a change and not stay on the disastrous course that he is now following.

I am anxious to hear from the witnesses.

Representative REUSS. Thank you very much.

Before we call our first witness this morning, I will include Senator Jepsen's opening statement for the record at this point, without objection.

[The opening statement of Hon. Roger W. Jepsen follows:]

OPENING STATEMENT OF SENATOR JEPSEN, VICE CHAIRMAN

Today's report of a 0.8 percent annual rate of growth in gross national product in the third quarter of this year is welcome news. Together with yesterday's news that housing starts and permits were up sharply in September, this signals the "light at the end of the tunnel," a resurgence in the American economy that can be translated into additional jobs for America's workers. It is the second consecutive quarter of real growth in output and, combined with the substantial fall in both the rate of price inflation and levels of interest rates in recent months, confirms that the recession is over.

The experience of recent times indicates that a 1 percentage point increase in gross national product means approximately 400,000 jobs for American workers. Today's news should give hope to the American public, a public that has been beset by naysayers who have been emphasizing anything that could be construed as a negative feature of recent American economic performance. Crude attempts have been made to compare present economic circumstances with those of the Great Depression of the 1930's, ignoring the fact that during that period employment fell by almost 20 percent while during the first 9 months of 1982, average employment is virtually unchanged from January 1981. Even the September level of employment is only two-tenths of 1 percent less than the January 1981 level.

Today's news, coming on top of yesterday's housing statistics, should cause those who have been waving the "bloody shirt" of depression for partisan political advantage to pause and consider the potential impact of their demagoguery on the state of the nation. Political license is one thing, but the deliberate twisting and distorting of the realities of American economic life—the conjuring of shadows on the wall—the economic rhetoric of the past few weeks—those are something else.

Representative REUSS. Mr. Bator, would you lead off, please.

STATEMENT OF FRANCIS M. BATOR, PROFESSOR OF POLITICAL ECONOMY, JOHN F. KENNEDY SCHOOL OF GOVERNMENT, HARVARD UNIVERSITY, CAMBRIDGE, MASS.

Mr. BATOR. I hope you will allow me to begin by saying how difficult it is to think about this committee without you, and indeed without you as chairman. It will be a loss to the country and especially, I think, a loss to the cause of economic enlightenment.

I am grateful for this opportunity to comment on the prospects of the U.S. economy. I will concentrate on the domestic rather than the international dimensions of our troubles, and on their cyclical aspects, on the timing and pace of recovery from the 1980–82 minidepression. Except for inflation I will say little about longer term structural difficulties.

First, the next few months. When will the U.S. economy turn, and will it turn up or down?

Absent a further change in policy, I believe that the chance of an upturn the next 3 to 6 months is at best 50–50. Another substantial decline that would drive the unemployment rate to 11–12 percent is entirely possible. I believe the economy is near stalling speed.

If the above judgment is right, and considering the damage that a further decine would inflict, there exists a powerful case for downside insurance. Specifically, I would urge that:

First. During the next few weeks the Federal Reserve actively drive down short-term interest rates and thereafter that it continue to accommodate the demand for M_1, M_2, and M_3 until there is available reliable evidence that total output and real final spending have turned up.

Second. If the statistics that become available during November suggest continued weakness, the postelection Congress should change to January 1 the effective date of the personal income tax reduction now scheduled to take effect on July 1. It would be a modest, and in some respects awkward move, but by giving the economy a small upward push it might just help avert another decline. At the same time, it would be useful if the legislative record reflected congressional awareness that the prospective outyear, midrecovery deficit will have to be reduced.

Under current economic circumstances, the chance is in my opinion negligible that the above actions would trigger an uncontrollable spending boom that would tighten markets too fast and thus cause the underlying wage-price inflation to accelerate. Like a coiled spring the economy is not. In the near term the balance of danger is, I believe, all the other way.

Argument. Most of the serious forecasts I have studied say that real output will increase during the fourth quarter by a little and pick up speed during the winter and spring. My reasons for concern, nevertheless, are as follows:

How aggregate spending will behave during the next few months is, I believe, much more uncertain than has usually been the case just before a cyclical upturn. For many months the economy has been operating outside the range of postwar observation. The U.S. record does not contain evidence on spending behavior in an environment of double-digit unemployment, less than 70 percent capacity utilization, still near record high real interest rates, and widespread business illiquidity. It is the only record available. The most likely story drawn from it is the most likely story. But it is only that. We should take at least low-cost steps to hedge against unpleasant surprise.

When considering the arithmetic of an upturn, it is important to keep in mind that as long as inflation persists at an annual rate of, say, 5 percent, annualized nominal spending has to increase by about $40 billion each quarter merely to keep output level, and by $60–$65 billion to keep the unemployment rate from increasing.

What is the likelihood of such spending growth during the next two quarters? The optimistic forecasts rely on large increases in Federal purchases, in residential construction, and in personal consumption, and also on a reduction in inventory disinvestment. The change in inventory investment is predicated on substantial inventory liquidation during the third quarter. On the evidence available at this writing—and as I now look at the figures on the basis of the evidence announced this morning—one has to wonder whether any such liquidation took place. A more likely bet, I think, is that final sales and production have been in approximate balance.

Consumption is critical. For an appreciable upturn it will have to increase during the next 6 months much faster than disposable income. Will it? I think the answer is unknowable. The monthly figures do not suggest that personal saving rates took an uncharacteristically large post-tax-cut jump in July or August. There is therefore no reason to count on a larger than characteristic delayed effect from the July 1 tax cut and social security increase. The fear and uncertainty caused by record unemployment, though difficult to gage, must be reckoned a very large minus.

Concerning monetary policy, it may seem churlish to ask the Fed to change its policy once again. But if I read Chairman Volcker right, while they intend to accommodate above-target increases in the demand for money at current nominal interest rates, and to allow below-target increases to cause interest rates to decline further, they do not intend to expand the monetary base fast enough actively to drive short-term interest rates down if demand for money happens to grow at above-target rates. Yet doing that in the near term would be the right medicine. At least it would be the right medicine if I am right that the economy is near stalling speed and that the damage caused by its further decline would far outweigh the negligible danger that such active easing would produce a difficult-to-control spending boom.

I recognize that the proposal to cut taxes as of January 1 is both awkward and quite possibly too modest to matter. It is awkward, because if the economy does turn up soon, by 1984 we will probably have to raise taxes. The recommendation looks like an attempt at fine tuning, and it may be much too fine in two senses: As preventive, it may well be too late as well as too small; and if it fails and the economy takes another dive—not a probability, but a 1 in 4 possibility—we would have to take much more expansionary fiscal action.

So why bother? Because it might help. Because with idle capacity, business illiquidity and unemployment, lower interest rates may not alone suffice quickly to stimulate much extra spending for goods and services. It's like trying to push on a string. Because if accommodated by the Federal Reserve it cannot do much harm. Because if we don't bother and the economy stays flat or weakens some more, we will regret not having tried.

Now let me turn, Mr. Chairman, to the next 1 to 4 years. What kind of a recovery will we get?

What kind of a recovery we will get depends on what kind of fiscal and monetary policies we adopt. That in turn should reflect the kind of recovery we want; on which of the feasible one-to-four paths of output, employment, and associated inflation we like best or dislike least. The choices are many. I will sketch just four.

One choice would be a relatively rapid recovery with worsening inflation. Because we are currently suffering a $300 billion per annum gap between the actual output of the economy and its potential output we could opt for a path of rapid growth, say 6½ to 7 percent per year for the next 2 years, and a consequent one and a half to two points annual reduction in the unemployment rate. Real income would grow rapidly in the absence of direct wage restraint so I'm afraid would the price level. At best the underlying wage-price inflation would stop slowing down. Much more likely, such a rapid though not atypical recovery would cause wage-price inflation to reaccelerate.

As a second choice, we could aim for a spending-output-employment path that would slow down the core inflation even more, to perhaps around 2 percent per year by 1985. To bring that about without direct wage restraint would require enormous quantities of slack during the next 2–3 years.

One possible target path would entail trying to hold the average unemployment rate around 9 to 10 percent for another 2 years. That would require that real spending be allowed to grow only a little faster than 2½ percent per year. The direct 2-year cost would be in the neighborhood of $500 billion in unproduced real output and income. If we follow this opinion we will have reduced the underlying inflation rate from 9 percent to about 1–2 percent, but the 6-year direct cost will have been about $1 trillion, approximately $15,000 per American family. And that does not count the continuing productivity loss due to the consequent loss in capital formation.

As a third possibility we could aim for a gradual recovery, modest by historical standards, especially in light of the current size of the utilization gap. A growth rate of 4½ to 5 percent per year during the next 3 years would draw the unemployment rate down by, at best, one point a year. Barring changes in real oil or food prices, core inflation would probably get stuck somewhere between 5 and 7 percent.

The fourth option: We could add direct wage restraint to the policy mix. If we were willing to supplement fiscal and monetary policy with a serious program of wage restraint we would have a good chance of achieving both a relatively rapid recovery and further improvement in the core inflation. That is the option, Mr. Chairman, I would vote for. But I fear it is a losing vote. Middle-of-the-road opinion seems to favor the third approach, a very gradual recovery with no deterioration in core inflation, and if that is to become our choice, changes have to be made in both fiscal and monetary policy beyond the emergency measures recommended above.

Fiscal policy. It is generally thought that for gradual growth, what I called option 3, the prospective 1984–86 deficits are still too large. While forecasting 2 to 3 years ahead is hazardous, I tend to share that view.

Mr. Chairman, if I am to discuss fiscal and monetary policy it will take me about 4 or 5 minutes longer. I could skip fiscal and go to monetary. What would be your preference?

Representative **Reuss.** Let's hear you. I think the others would like to.

Mr. **Bator.** I tend to share the view that, for gradual recovery, the out-year deficits are too large, and will come back to it. First, however, I would like to make two preliminary points about deficits in general. Both are familiar to members of this committee, but they are often misunderstood elsewhere.

First. The size of a deficit reveals little about what the budget is doing to the economy. Because it reflects also what the economy is doing to the budget, it is consequence as well as cause. For a usable one-number indicator one has to look to changes in a construct called the high employment deficit, or better still, to changes in the ratio of the high employment deficit to GNP. It is called fiscal thrust.

Second. Budget deficits of any particular size, including high employment deficits are not good or bad as such. They are too large, too small, or about right, according to what one wants the budget to do to the economy. For example, one must, I think, be thankful for the very large deficits of calendar 1982. If we had tried to make them smaller by cutting spending or raising current taxes, we would have reduced the sum of private plus public spending and caused a reduction in output and employment; we would have made the recession worse.

To be sure, as a consequence of the deeper recession inflation would be a little slower. Moreover, because nominal income would also be lower, so would the demand for money. As a result, with no change in the supply of money, interest rates would be somewhat lower, but not enough lower—and that is the critical point—to cancel the negative effect of the tighter budget on total spending and output. For that the Fed would have had to make the money supply grow much faster than it did, driving interest rates still lower by positive action. Until 2 weeks ago there was no reason to believe that the Fed might be willing to cooperate in such a shift in the fiscal-monetary mix. It follows that the 1982 deficits have been and are good deficits.

What about the prospective deficits? I have suggested above that a risk-averting strategy calls for making the early 1983 deficit larger. For 1984 and thereafter the answer depends again on which of the feasible paths of output and core inflation we wish the economy to follow, and, once again, on Federal Reserve policy.

If we wish to opt for the moderate 4 to 5 percent growth path—a one-point-a-year reduction in unemployment, no appreciable deterioration in wage-price inflation, but not further improvement either—then the consensus view is probably right that the deficits presently programed for fiscal 1985 and 1986, and maybe even for late 1984, are likely to produce too much fiscal thrust. For a while at least total spending for goods and services would tend to grow rapidly. If the consequent demand for money were to be accommodated by the Fed, we would have cheerful results with respect to the real economy, but unpleasant results with respect to inflation. If, alternatively, the Federal Reserve chose to step on the monetary brakes, the combination of slow money growth with initially fast, fiscally induced growth in spending, and therefore in the demand for money, would force interest rates to rise and the interest and credit sensitive components of spending would be squeezed. Within a few quarters tight money would win out over loose fiscal policy, recovery would stall, and we would suffer another nasty recession.

So if we want the gradual growth option, the midrecovery 1985 and 1986 fiscal deficits will probably have to be reduced.

Monetary policy in support of a gradual recovery. To bring about a gradual, 1-point-a-year reduction in the unemployment rate during the next 3 years output would have to grow at a rate of about 4½ to 5 percent per year. If along such a growth path the underlying rate of inflation were to remain in the 5 to 7 percent range—and that is the most likely outcome, barring supply-price shocks—then total nominal spending would have to grow at an average rate of 9½ to 12 percent. That will not happen if the Federal Reserve, after choosing a new base period for money supply some time this winter, persists in trying to adhere to its previously announced objective for the growth rate of the money stock, that is a 5½ percent growth calling for M_1 during 1983 and still lower ceilings beginning in 1984.

In the short run, quarter by quarter the demand for money is extremely volatile. That is why it does not make sense for the Federal Reserve to try to track a fixed money supply target. But over a period of a year or two 5½ percent M_1 growth will not sustain a 9½ to 12 percent rate of nominal spending growth. If a shortfall in spending could be relied on to slow down prices directly, in proportion, that would be fine. But in a sticky price economy like the United States a shortfall in spending will reduce output and employment quickly and reduce wage and price inflation only very gradually.

The conclusion. If we want a gradual recovery –the third option above—the Fed will have to abandon for good its announced growth rate ceilings for money supply. It could announce new, much higher ceilings and explain why that is necessary if we are to achieve a gradual recovery. Better by far it could announce that after 3 years of experimentation, experimentation that produced a 3-to 4-point improvement in the underlying inflation at the cost of 6 point years of extra unemployment and $450 billion of lost real income and output, that henceforth it intends to supply base money in whatever volume seems appropriate to the fiscal monetary task of making total spending track an agreed and announced 1- to 3-year target.

. It could explain further that in support of that objective it will pay attention to interest rates, credit supply, to M_1, M_2, M_3, and any other economic indicator that might improve its forecasts of spending behavior. Such a policy would require that there be all-government agreement on a total spending target and on the forecast consequences for output, employment, and the price level.

For the Fed the hardest part would be the loss of protection now afforded by the sometimes useful pretense of a kind of technocratic, apolitical value neutrality that helps protect its quasi-independent status and wards off questions of legitimacy.

Mr. Chairman, I will stop there. The last part of this testimony consists of a taxpayer's reflections on how to reduce the 1984–87 budget deficit. My conclusion, very briefly, is—and this entails value judgments—that (1) nondefense Federal spending ought to increase, not decrease. I can comment on that later if that would be of interest to you. (2) I believe we should stretch out the defense buildup, but only to a point. I think we do need a buildup focused mainly on conventional, forces, mobility, maintenance, operation, and training. Certainly we should not spend money on things like the MX. (3) It follows that virtually all of the deficit reduction that we probably will have to undertake for late 1984, 1985, and 1986 should come in the form of higher taxes. I do not believe that the United States is an overtaxed society. I think we should remember Justice Homes proposition that "taxes are what we pay for civilized society." Thank you, Mr. Chairman.

[The prepared statement of Mr. Bator follows:]

PREPARED STATEMENT OF FRANCIS M. BATOR

I am grateful, Mr. Chairman, for this opportunity to comment on the near-term and mid-term prospects of the U.S. economy. I should like first to say something about the immediate future, and then to go on, in Part II, to some questions concerning the pace and shape of a recovery once the economy has turned around. I will concentrate on the domestic rather than the equally important international dimensions of our problems, and on their cyclical aspects -- the timing and pace of recovery from the 1980-82(?) mini-depression. Except for inflation, I will say little about possible, longer-term structural difficulties. (In my opinion, symptoms of the former are too often misdiagnosed as evidence of the latter.)

I. The Next Few Months: When Will The U.S. Economy Turn, And Will It Turn Up or Down?

To state the case very briefly (I will make the argument at greater length below):

- Unless a further change is made in monetary policy, and perhaps also in fiscal policy, I believe that the chance of an upturn in real total spending and output during the next three to six months is at best fifty-fifty. Another substantial decline, that would drive the unemployment rate to 11 to 12%, is entirely possible. I believe that the economy is near stalling speed.
- If the above judgment is right, and considering the damage that a further decline would inflict, there exists a powerful case

for some downside insurance. Specifically, I would urge that

(1) During the next few weeks, the Federal Reserve actively drive down short term nominal interest rates, and thereafter, that it continue to accommodate the demand for M-1, M-2..., until there is available reliable evidence that total output and real final spending have turned up.

(2) If the statistics that will become available during November suggest continued weakness, the post-election Congress should change to January 1, 1983 the effective date of the personal income tax reduction now scheduled to take effect on July 1. It would be a modest, and in some respects awkward move, but by giving the economy a small upward push, it might just help avert another decline. (At the same time, it would be useful if the legislative record reflected Congressional awareness that the prospective out-year, mid-recovery and late-recovery deficits will have to be reduced.)

- Under current economic circumstances, the chance is negligibly small that the above actions would stimulate, or exacerbate, an uncontrollable spending boom that would tighten labor markets and goods markets too fast, and thus cause the underlying wage-price inflation to accelerate. Like a "coiled spring," the economy is not. In the near term, the balance of danger is all the other way. (I will argue in Part II below that in a year or so, if in the meantime the economy does turn up, we will confront difficult choices involving a trade-off between the speed of recovery and the speed of inflation.)

Argument

I am aware that most of the serious forecasts say -- or at least most of those I have studied -- that the recession has run its course, that real output will increase during the fourth quarter by a little and pick up speed during the winter and spring. My reasons for concern, and for suggesting a prompt, short-term policy change as a hedge, are as follows:

- How aggregate spending will behave during the next few months is, I believe, much more irreducibly uncertain than has usually been the case just before a cyclical upturn. For many months, the economy has been operating outside the range of post-war observation. Forecasts are based on regularities found in the record of the past. The U.S. record does not contain much direct evidence on household and business spending in an environment of double-digit unemployment, less than 70% capacity utilization, still near record high real interest rates, and widespread business illiquidity. It is the only record available; the most likely story drawn from it, by the use of good economics, good econometrics, and good sense, is the most likely story. But it is only that. We should be prepared for surprise and take at least low-cost steps to hedge against *unpleasant* surprise.

- When considering the arithmetic of an upturn (or downturn), it is important to keep in mind that, as long as inflation persists at an annual rate of, say, 5%, total annualized nominal spending has to increase by about $40 billion *each quarter* merely to maintain output constant. (Five percent is a low estimate of the present pace of the inertial drift in the price level, a consequence of the wage-price spiral.) To keep the unemployment rate and idle capacity from increasing, the quarterly increment in annualized nominal spending has to be $60 to $65 billion at current levels. (Because the labor force and productivity[1] are both increasing, real output has to grow at an annual rate of about 2½% merely to keep the unemployment rate and idle capacity level; with inflation at 5 to 6%, total nominal spending has to grow at a rate of at least 5 + 2½ = 7½%. At current levels that translates into quarterly increments of $60 to $65 billion.)

- What is the likelihood of such spending growth during the next two quarters? With state and local purchases, business fixed investment, and net exports predictably weak (the last perhaps very weak), the optimistic forecasts rely on large increases in Federal purchases, in residential fixed investment (at least on a seasonally adjusted basis), and in personal consumption, and also on a reduction in inventory dis-investment. The Federal purchase estimates are tolerably reliable, and so is a part of the projected increase in residential construction (it is driven by housing starts already on the books). But the change in inventory investment is predicated on substantial inventory liquidation during the third quarter. On the evidence available at this writing, one has to wonder whether any such liquidation took place; a more likely bet, I think, is that final sales and production have been in approximate balance.

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[1] I.e., cyclically adjusted productivity (in other words, productivity evaluated at any constant rate of capacity utilization and employment.)

- Because it accounts for two-thirds of the total, consumption expenditure is critical. For an appreciable upturn, consumption will have to increase during the next six months much faster than disposable income. Will it? I think the answer is unknowable. The (unreliable) monthly figures do not suggest that personal saving rates took an uncharacteristically large post-tax-cut jump in July-August. There is therefore no reason to count on a larger than characteristic delayed effect from the July 1 tax cut and social security increase. The wealth-effect of the recent stock market boom will be a (very small) plus. Aggregate household liquidity will be a bigger plus. The reductions in consumer interest rates will be a plus if they appreciably exceed the reduction in anticipated inflation. The reduction in household net worth since 1981, and the current decline in interest income, will be a minus. Most important, the fear and uncertainty caused by the record unemployment rate, though difficult to gauge, must be reckoned a very large minus.

- Concerning monetary policy, it may seem churlish to ask the Federal Reserve to change policy once again, so soon after it has at long last assured us that, for the time being, it would not respond to a run of large Friday afternoon M-1 statistics by tightening its base-money tourniquet and driving interest rates higher. Moreover Mr. Volcker is a master of ambiguity, not necessarily a bad thing in a central banker. But if I read him right, while the Federal Reserve intends to accommodate above-target increases in the demand for money at current nominal interest rates (and to allow below-target increases to cause interest rates to decline further), they do not intend to expand the monetary base fast enough actively to drive short-term interest rates down if demand for money happens to grow at above target rates. Yet doing that, in the near-term, would be the right medicine. At least, it would be the right medicine if I am right that the economy is near stalling speed, and that the damage caused by its further decline would far outweigh the negligible danger that such active monetary easing during the next few months would produce a difficult-to-control spending boom. (I recognize that this last point contains both a contingent prediction and a value judgment that the anti-inflationary benefit of letting the unemployment rate go to 11-12% is not worth the damage done to the real economy. For more comment on the inflation versus unemployment tradeoff see Part II below.)

- I recognize also that the proposal to cut taxes as of January 1, 1983 is both awkward and, quite possibly, too modest to matter. It is awkward because, if the economy does turn up soon, by 1984 we will probably have to raise taxes in order to avoid an excessive, short-lived boom that would lead to a credit crunch, and thence to another recession. The recommendation looks like an attempt at "fine tuning," and it may be much too "fine" in two senses. As a preventive, it may well be too late as well as too small, even in combination with active monetary ease. And if it fails, and the economy takes another dive (not a probability, but in my opinion a one-in-four possibility), we would have to take much more aggressive expansionary fiscal action. (If successful, that policy too would have to be reversed in a couple of years.)

- So why bother with the tax-date change? Because it might help. (I am aware of the permanent income hypothesis, but only half believe it.) Because idle capacity, business illiquidity, and unemployment may frustrate even a policy of aggressive monetary ease; lower interest rates by themselves may not quickly stimulate much extra spending for goods and services. Because, if accommodated by the Federal Reserve, as it should be, the tax-date change cannot do much harm; given the state of the economy, it certainly won't be too expansionary. Because, if we don't make the effort, and the economy stays flat or weakens some more, we will regret not having tried.

II. The Next One to Four Years: What Kind of Recovery?

What kind of recovery we will get depends on what kind of fiscal and monetary policies we adopt. That choice in turn should reflect the kind of recovery we want -- which of the feasible one to four year paths of output, employment, capacity utilization, and associated inflation we like best, or dislike least. The choices are many; I will sketch just four. (For the sake of schematic clarity, and at the risk of an excess of numerical precision, I will rely on the persistent regularities that have characterized the relations between output, employment, and core inflation in the United States during the past two or three decades, and will omit the usual caveats. Those are the best-bet numbers available; the macroeconomic managers have no choice but to make use of them in a gingerly and continuously observant way. I will also assume that the economy does turn up this winter, that the unemployment rate doesn't rise much above 10%, and that during the next three years we are not once again confronted by enormous supply price shocks of the sort that damaged us in 1972-4 and again in 1979.)

(1) Relatively rapid recovery and worsening inflation. Because we are currently suffering a gap of $300 billion per year between the actual output of the economy and its potential output (i.e., the output that the economy would be producing if the unemployment rate were 6% rather than the current 10%, and capacity utilization in manufacturing about 85% rather than the current 69%),

we could opt for a path of rapid growth in total real spending and output, say 6½ to 7% per year for the next two years, and a consequent relatively rapid reduction in the unemployment rate on the order of 1½ to 2 percentage points each year. Real wages, real profits, capacity utilization, and realized productivity would all grow rapidly. Unfortunately, in the absence of direct wage restraint, so would the price level. At best, the underlying wage-price inflation, having been slowed down from about 9% per year to about 5½ to 6½% by the 6 point-years of excess unemployment since 1979 (i.e., that in excess of 6%), would stop slowing. Much more likely, such a rapid (though not atypical) recovery would cause wage-price inflation to reaccelerate.

(2) High unemployment and decelerating inflation. Alternatively, we could aim for a spending-output-employment path that would slow wage-price inflation down to around 2%(±) per year by 1985. To bring that about without direct wage restraint would require that the macromanagers continue to operate the economy with enormous quantities of slack during the next 2 to 3 years. One possible target path would entail trying to hold the average unemployment rate at around 9 to 10% for another two years. That would require that real spending and output be allowed to grow only a little faster than the approximately 2½% per year needed to keep the unemployment rate constant. The direct two-year cost of such a program of continuing disinflation would be in the neighborhood of $500 billion in unproduced real output and income (as compared to a 6% unemployment path). If we choose this option, we will have reduced the underlying inflation rate from 9% in 1979 to about 1 to 2%. The six-year direct cost will have been about one trillion dollars, approximately $15,000 per American family. And that does not count the continuing productivity loss due to the reduced volume of capital formation.

(3) Gradual recovery with core inflation stuck at 5 to 7%
As a third possibility, the macromanagers could aim for a gradual recovery, modest by historical standards, especially in the light of the current size of the employment and utilization gap. A growth rate of 4 to 5% per year during the next three years would draw down the unemployment rate by, at best, one point a year. Barring adverse changes in real oil or food prices, core inflation would probably get stuck somewhere between 5% and 7%. As compared to the rapid recovery path, the real output and real income cost would come to about $200 to $300 billion.

(4) Adding wage restraint to the policy mix. If we were willing to supplement fiscal and monetary policy and sensible old-fashioned supply-side measures with a serious program of wage restraint, we would have a good chance of achieving both a relatively rapid recovery and further improvement in the core inflation. The object of such a program would be to shrink directly the gap between the rate of increase in money wages and salaries on the one hand, and the (only slowly alterable) underlying rate of increase in productivity on the other.

My own vote is for the fourth option, but I fear it is a losing vote. Direct wage restraint does not seem to be in the political cards, at least during the next two years. Middle-of-the-road opinion seems to favor the third approach: a very gradual recovery with no deterioration in core inflation. If that is to become our choice, changes will have to be made in both fiscal and monetary policy, beyond the immediate emergency measures recommended above.[1]

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[1] Some people believe that the '80-82 double-dip recession has already brought about an appreciably larger than 3 point "norm-shift" in wage inflation and, further, that we could manage even a fairly rapid recovery without causing inflation to reaccelerate. A variant of that view asserts that we can combine moderate recovery with continuing fairly rapid improvement in inflation. They rest their case on the relatively rapid deceleration shown by the (noisy) wage statistics during the past 9 months. Maybe so. We have no sustained postwar experience of 9 to 10% unemployment rates; perhaps they are causing a qualitative break in wage inflation. If so, the numerical tradeoffs outlined above are all too pessimistic. It would not be prudent to bet that way. As of now, the hope that we could have both rapid recovery and continued deceleration in core inflation without a serious policy of direct wage restraint strikes me as a low probability bet.

Fiscal Policy in Support of a Gradual Recovery

It is generally thought that, for gradual growth, the deficits built into the prospective Federal budgets for '84-'86 are likely still to be too large. While forecasting two to three years ahead is hazardous (and in this instance not entirely necessary), I tend to share that view, and will come back to it. First, however, I would like to make two preliminary points about deficits in general. Both are familiar to members of this Committee, but they are often misunderstood elsewhere.

(1) The size of a deficit reveals little about what the budget is doing to the economy. Because it reflects also what the economy is doing to the budget, it is consequence as well as cause. For a useable one-number indicator of what the budget is doing to the macroeconomy, one has to look to changes in a construct called the high-employment deficit (or surplus), or, better still, to changes in the ratio of the high-employment deficit to GNP -- it is called "fiscal thrust." (Actually, for any given short period, changes in any standardized, income-adjusted deficit would do. One need not normalize relative to some estimated "high employment" income.)

(2) Budget deficits of any particular size, including high employment deficits (or changes therein), are not good or bad as such. They are good or bad -- too large, too small, or about right -- according to what one wants the budget to do to the economy: to total public plus private spending for produced goods and services, and thus to total output, employment, and inflation.

For example, and in light of the recently abandoned (one hopes) money supply objectives of the Federal Reserve, one must I think be thankful for the very large deficits of calendar 1982. If we had tried to make them smaller by cutting spending, or raising current taxes (thereby reducing after tax income), we would have reduced the sum of private plus public spending, and caused a reduction in output and employment. In other words, we would have made the recession worse.

> To be sure, as a consequence of the deeper recession, inflation would be a little slower. Moreover, because nominal income would also be lower, so would the *demand* for money, i.e., for currency and checkable deposits. As a result, with no change in the *supply* of money provided by the Federal Reserve, interest rates would be somewhat lower. *But not enough lower -- and that is the critical point so widely misunderstood -- to cancel the negative effect of the tighter budget on total spending and output*. For that, the Fed would have had to make the money supply grow much faster than it did, driving interest rates still lower by positive action. Until two weeks ago, there was no reason to believe that the Fed might be willing to cooperate in such a shift in the fiscal-monetary mix by significantly and persistently breaching or revising its money-supply targets. It follows that the 1982 deficits have been and are good deficits.

What about the *prospective* deficits? I have already suggested that, even if the Federal Reserve follows an actively expansionary policy during the next few months (as I think it should), a risk-averting strategy calls for making the early 1983 deficit larger. For 1984 and thereafter, the answer depends again on which of the feasible paths of output, employment, and associated core inflation we wish the macro-economy to follow (and, once again, on the Federal Reserve's intentions with respect to the supply of base money).

If we wish to opt for the moderate, 4 to 5% growth path -- the path of gradual recovery, a one-point a year reduction in unemployment, and no appreciable deterioration in wage-price inflation, but no further improvement either -- then the consensus view is probably right that the deficits presently programmed for fiscal years '85 and '86, and maybe even for late '84, are likely to produce too much fiscal thrust. For a while at least, total public plus private spending for goods and services would tend to grow very rapidly. If the consequent rapid growth in the demand for money were to be accommodated by the Federal Reserve at declining or even constant real interest rates, we would have cheerful results with respect to output, real income, employment, and profitability, but unpleasant results with respect to inflation. If, alternatively, the Federal Reserve chose to step on the monetary brakes, the combination of slow base-money growth with initially fast fiscally-induced growth in total spending (and therefore in the demand for money) would force interest rates to rise and credit to become tight. All the interest- and credit-sensitive components of spending would be squeezed. Within a few quarters, tight money would win out over loose fiscal policy, recovery would stall, and we would suffer another nasty recession. As Arthur Okun used to point out, tight money makes for grabby brakes. It is especially so when tight money is accompanied by a stimulative fiscal policy.

Monetary Policy In Support of a Gradual Recovery.

To bring about a gradual, one-percentage-point a year reduction in the unemployment rate during the next three years, output would have to grow at a rate of about 4½ to 5% per year. If, along such a growth and employment path, the underlying rate of inflation were to remain in the 5 to 7% range -- and that is the most likely outcome, barring large supply-price shocks -- then total nominal spending would have to grow at an average rate of 9½ to 12%. That will not happen if the Federal Reserve, after choosing a new base period for money supply sometime this winter (it is called "re-basing"), persists in trying to adhere to its previously announced objectives for the growth rate of the money stock (e.g., a 5½ growth-rate ceiling for M-1 during 1983, and still lower ceilings beginning in 1984).

In the short run, quarter by quarter, the demand for money is extremely volatile in relation to interest rates and income growth -- that is why it does not make sense for the Fed to try to track a fixed money supply target. But over a period of a year or two, 5½% M-1 growth will not sustain a 9½ to 12% rate of nominal spending growth. If a shortfall in spending could be relied on to slow down prices directly, in proportion, that would be fine. But in a sticky price economy like the U.S., a shortfall in spending will reduce output and employment quickly, and reduce wage and price inflation only very gradually.

The conclusion: if we want a gradual recovery -- the third option above -- the Fed will have to abandon for good its announced growth-rate ceilings for money supply. It could announce new, much higher ceilings and explain why that is necessary if we are to achieve a (gradual) recovery. Better by far, it could announce that after three years of experimentation -- experimentation that produced a 3 to 4 point improvement in the underlying inflation rate at the cost of 6 point-years of extra unemployment and $450 billion of lost real income -- henceforth it intends to supply base money in whatever volume seems appropriate to the fiscal-monetary task of making total spending and its main components track an agreed and announced 1 to 3 year target. It could explain, further, that in support of that objective, it will pay attention to interest rates, credit supply, M-1, M-2..., and any other economic indicator that might improve its forecasts of spending behavior. Such a policy would require that there be agreement within the government on a total spending target and on the forecast consequences for output, employment, and the price level. For the Federal Reserve, the hardest part would be the loss of protection inherent in the fiction (in a sticky price economy it is a fiction) that monetary policy is value neutral, and therefore apolitical. Once the Fed is seen as making explicit choices between unemployment and inflation, questions of legitimacy are likely to threaten its often useful quasi-independent status.

III. Postscript: A Taxpayer's Reflections on How to Reduce the '84-87 Budget Deficit

Evidently, we can try to cut real non-defense Federal spending still more, stretch out the defense buildup, and/or raise tax rates and thereby repair the damage done by the tax-cutting orgy of 1981. The choices entail value judgments. My own values say that:

- Real non-defense Federal spending needs to be increased, not decreased. While I would eliminate the over-indexing of social security and tighten up on some other entitlement programs, spending on a variety of activities that benefit the poor, the central cities, the quality of public services, the public capital stock, education, and research and development ought in my opinion to go up rather than down.

- We should stretch out the defense buildup, but only to a point. I believe we need a buildup, mainly centered on maintenance and operations, on the readiress and mobility of forces, on inventories, on conventional combat capabilities in general. Given the bomber and submarine force (with cruise missiles and Trident II), and a cheaply enhanced Minuteman force, the "window of vulnerability" notion is I think absurd, and therefore irresponsible. We should certainly not be spending money on a vulnerably based and therefore destabilizing MX.

- It follows that virtually all of the deficit reduction should take the form of higher taxes. It is not true that the United States is an over-taxed society. However one measures it -- by the ratio of total taxes to national income, of government purchases to GNP, of total government expenditure to GNP -- government in the United States takes a substantially smaller cut than in virtually any other major advanced industrial country except Japan: West Germany, Canada, France, Britain, Italy, Sweden, Austria, Belgium, and the Netherlands all pay a higher proportion of their national income in taxes. By one measure, the Swiss government does less; by another it does more. Undoubtedly a lot of what the government does is done inefficiently; the same is true about a lot of what private industry does producing for private use. But it is not true that our economic troubles of the past fifteen years have been caused by too much government taxing and spending. When considering what we should do about the Federal budget in the next few years, we had better remember Justice Holmes' proposition that "taxes are what we pay for civilized society."

Representative REUSS. Thank you, Mr. Bator.
Mr. Dalio.

STATEMENT OF RAYMOND T. DALIO, PRESIDENT, BRIDGEWATER ASSOCIATES, WILTON, CONN.

Mr. DALIO. Mr. Chairman, Congressman Mitchell. It's a great pleasure and a great honor to be able to appear before you in examination of what is going wrong with our economy.

Following the economy of the last few years has been rather like watching a mystery thriller in which you can see the dangers lurking around the corner and want to yell a warning but know it won't be heard.

The danger in this case is depression. Unfortunately, depression is a word which is used sensationalistically and not enough diagnostically. Although it's been a long time since the economy has suffered from one, there is such a disease as depression which we as economists should know how to diagnose. Today's economists are about as familiar with depressions as today's physicians are with long dormant plagues. Just as a physician wouldn't want to treat pneumonia as though it were a cold, an economist wouldn't want to make the mistake of misdiagnosing a depression by thinking it's a recession.

Contrary to popular belief, a depression is not simply a more severe version of a recession; it's an entirely different degenerative process. If depressions were simply more severe versions of recessions, and one just used measures of severity such as the rate of unemployment or the rate of falling real GNP to differentiate between them, there would be no means of distinguishing the early stages of a depression from the late stages of a recession as they both are comparably severe.

However, by understanding the processes that cause depressions to become more severe than recessions it's easy to distinguish between them. While a recession is a self-correcting economic contraction in which liquidity increases, a depression is a self-feeding contraction in which liquidity is being reduced. Normally in a recession inventories are liquidated, borrowings decrease, money supply growth slows, and interest rates decline. Various measures of liquidity, such as the ratio of current assets to current liabilities and the percentage of corporate debt which is short term in turn reflect this reliquification in a recession. However, in a depression in order to raise liquidity inventories are liquidated and borrowings increase; as a result, inflation falls while interest rates rise. Measures of liquidity in turn show it declining rather than increasing in a depression.

Since 1800 there have been 14 major depressions in the United States, all progressing in a similar manner. This is what we call the depression process. This process can be segmented into four phases.

In phase 1 the economy becomes debt burdened and illiquid, which makes it what we call depression prone. In other words, the demand for money becomes highly inelastic and money becomes tight.

This leads to what we call phase 2, or a liquidity crisis, at which time borrowings increase and inventories are liquidated. This causes interest rates to rise while the economy contracts, thereby worsening the economy's liquidity problems.

The depression process advances from phase 2, liquidity crisis, to phase 3, which we call failure, when it moves from gasping for liquidity to failing for lack of it. Failure is a lending crisis motivated contraction in which the economy is no longer responsive to monetary stimulation. In other words, it's not a traditional recession; that is, it's not a contraction primarily motivated either by reaching a high level capacity or reaching a level of illiquidity; it's a contraction which is motivated by a lending crisis in which the economy is not responsive to monetary stimulation.

After this contraction runs its course the depression enters what we call phase 4, the period of economic stagnation.

As it would take a considerable amount of time to examine the economy's evolution to this point, suffice it to say that from the late 1940's until 1979—the July 1979 appointment of Paul Volcker—the ratio of total debt to GNP increased to the highest level since the Great Depression at the same time as liquidity was severely reduced.

If you would be kind enough to turn to chart 1 at the rear of the prepared statement you can see ratio of total debt to GNP at the top portion of the chart. That ratio goes back to 1916. The large spike up in the 1930's was a result primarily of a falling GNP and it conveys how a falling economy increases the debt burden. But debt doesn't decline as GNP does and so, as a result, the ratio of debt to GNP increases. You can see that the debt to GNP ratio has increased consistently from the early 1950's until the 1979 period.

Since the October 1979 shift in monetary policy the Fed, in its battle against inflation, substantially further drained liquidity. As a result, for the last 3 years the economy has been in a protracted liquidity crisis. Interest rates have consistently held higher than at any time in the previous 100 years at the same time as capacity utilization has declined to near the lowest level since the Great Depression.

Extended severe illiquidity inevitably causes economic failure. I repeat, that's a lending crisis motivated contraction in which the economy ceases to be responsive to monetary stimulation. This happens when large numbers of borrowers are unable to meet their debt service obligations. This reduces both the ability and the willingness of lenders to extend credit, which further constricts the flow of funds to illiquid borrowers, in turn causing more failures.

Since the banking system is the Federal Reserve's only conduit for reliquifying the economy, if bankers are less willing to lend it follows that the Federal Reserve is less able to revive the failing economy. This signals the beginning of what we call the failure phase—phase 3 of the depression process.

The economy is now teetering on the brink of failure. Like the last months of 1979, most recently, or the middle months of 1929, more appropriately, the economy is now in a brief yet critically important transition period. In late 1979 the transition was from a decade of inflationary expansion to 3 years of liquidity crisis. In mid-1929 the transition was from a decade of extraordinarily rapid economic growth to 5 years of failure.

The economy is now in transition from 3 years of liquidity crisis to a period of either failure or much higher levels of inflation. The economy's extreme illiquidity and leveraged condition implies that a large enough injection of liquidity to avoid failure would cause hyperinflation. By that I mean 15 to 18 percent by 1984.

The economy is now too illiquid to allow a return to stagflation, which is the successful balancing of the inflation and weak economy alternatives.

Virtually all statistics reflecting the economy's rate of activity indicate it is essentially flat. The rate is consistent with capacity utilization around 70 percent, real GNP about $1,480 billion, and the index of industrial production around 137.

Unfortunately, at this level of activity a stable economy is a deteriorating economy. While it is widely assumed that an economy which is expanding is getting stronger, changes in the economy's health are not primarily a function of changes in its direction but rather the rate at which it is operating. For example, a falling economy operating at 85 percent of capacity will be strengthening while a rising economy operating at 70 percent of capacity will be deteriorating. While the economy is now essentially flat, businesses are failing at a rate which is higher than at any time since 1933.

I'd like to turn your attention to chart 20, then also ask to turn your attention to charts 11 and 12, flipping between them.

Chart 11, if you were to use real GNP—that's that dashed line there—shows that essentially the economy has been roughly flat since the beginning of the year.

Turn to chart 20. You see that through that period of time there has been a consistent increase in business failures. This reflects that a flat economy is a deteriorating economy.

This failure rate will continue to rise until capacity utilization increases to at least 78 percent. However, rather than thinking of the economy as being homogeneous, it would be more accurate to think of it as being two-tiered, with interest rate sensitive sectors on the brink of failure and noninterest rate sensitive sectors still strong.

Since there is no way for the economy as a whole to remain immune from a bankruptcy crisis among the interest rate sensitive sectors, in order to assess the probability of failure it's this latter group which should be examined.

While it is important to recognize that the economy as a whole is headed for failure operating at under 70 percent of capacity, it's even more essential to consider the implications of little or no improvement among the interest rate sensitive sectors of the economy, such as autos, construction, airlines, lumber, steel, heavy equipment, et cetera, which are operating at less than 55 percent of capacity, and mining companies and farmers who are selling substantially below their costs of production.

In aggregate, the financial health of this large, interest rate sensitive sector of the economy is deteriorating rapidly. Its health will continue to deteriorate and failures among this sector will continue to rise unless there is an enormous reliquification.

We estimate that if the economy remains flat or improves only modestly the rate of business failures will increase by over 50 percent in the next 6 months. With the rate of business failures already unsustainably high, and given the fact that it would have to decline significantly in order to avoid failure, we can continue to assess that the odds are in favor of failure.

Since we're forecasting failure—we say the odds are in favor of failure—while other economists are forecasting imminent recovery, obviously our understanding of how the economy works must be appreciably different from theirs. Specifically, our disagreement concerns liquidity.

Based on our understanding of economics, the popular forecast that the economy will turn up at the same time as interest rates and inflation fall is impossible. We don't understand where the increased liquidity needed to both fuel an expansion and cause interest rates to decline will come from if not accompanied by an inflationary acceleration in the money supply.

The popular explanation that when the economy turns up over the next few months it will somehow produce enough liquidity to finance the expansion and allow interest rates to decline but that this increased liquidity will not show up in accelerated, hence inflationary, money suppy makes no sense to us.

By contrast our projections are based on the following three simple assumptions:

(1) Over the last 3 years the economy has been in a liquidity crisis.

(2) Unless there is an immediate reliquification there can be no economic upturn accompanied by lower levels of interest rates. As a result, the rate of business failures and loan defaults will continue to rise and cause failure. Again, failure is a lending crisis motivated contraction in which the economy isn't responsive to monetary stimulation.

(3) There is no such thing as a noninflationary reliquification. There is no way for capacity utilization to significantly increase at the same time as interest rates fall without the Federal Reserve flooding the banking system with liquidity, the banking system in turn flooding the economy with loans, and the money supply growth and inflation accelerating.

The economy is now flat, teetering on the brink of failure. The Fed, growing more concerned about this precarious position, has shifted its posture from pushing the economy toward the brink to simply watching it teeter. If it starts to go over, they'll attempt to save it, and if it moves away, they'll push it right back. Where this balancing act will lead will become more apparent over the next several weeks.

Although we're confident that failure and much higher levels of inflation are now the alternative, we are by no means certain which of these alternatives will come to pass.

Whether we are headed for an extended period of failure or much higher levels of inflation hinges first on whether the economy responds to the Federal Reserve's stimulation, which there are real doubts about—the Federal Reserve has basically pursued a stimulative monetary policy since May, and as of yet there has been no significant response—and if it does respond, on whether the Fed is willing to finance monetary growth at more than double its targeted rates.

Given a normal 2- to 4-month lag between stimulation and response, we'd certainly expect to know if the economy is responding within a few weeks, and if it does, with all the aggregates above the Fed's targets, we'd expect to see how the Fed will react shortly thereafter. If the Fed pursues its policy we'll get a recovery much like the third and fourth quarter 1980 recovery in which interest rates, the prime rate, bottomed at 11 percent and inside of 8 months doubled to 22 percent as they choked off the recovery.

That, Mr. Chairman, is the end of my statement.

[The prepared statement of Mr. Dalio, together with an attachment, follows:]

PREPARED STATEMENT OF RAYMOND T. DALIO

Just as a physician wouldn't want to treat pneumonia as though it were a cold, an economist wouldn't want to make the mistake of misdiagnosing a depression by thinking it's a recession. Contrary to popular belief, a depression is not simply a more severe version of a recession - it's an entirely different degenerative process. If depressions were simply more severe versions of recessions and one just used measures of severity such as the rate of unemployment or the rate of fall in GNP to differentiate between them, there would be no means of distinguishing the early stages of a depression from the late stages of a recession as they are both comparably severe. However, by understanding the processes that cause depressions to become more severe than recessions it's easy to distinguish between them. While a recession is a self-correcting economic contraction in which liquidity increases, a depression is a self-feeding contraction in which liquidity is reduced. Normally, in a recession, inventories are liquidated, borrowings decrease, money supply growth slows and interest rates decline. Various measures of liquidity such as the ratio of current assets to current liabilities and the percentage of corporate debt which is short term in turn reflect this reliquification. However, in a depression, in order to raise liquidity, inventories are liquidated and borrowings increase; as a result, inflation falls while interest rates rise. Meesures of liquidity in turn show it declining rather than increasing.

Since 1800 there have been fourteen major depressions in the U.S., all progressing in a similar manner. This is what we call the depression process. This process can be segmented into four phases. In Phase 1, the economy becomes debt burdened and illiquid which makes it depression prone - in other words, the demand for money becomes highly inelastic and money becomes tight. This leads to a liquidity crisis (Phase 2) - at which time borrowings increase and inventories are liquidated. This causes interest rates to rise while the economy contracts thereby worsening the economy's liquidity problems. The depression process advances from Phase 2 (liquidity crisis) to Phase 3 (failure) when it moves from gasping for liquidity to failing for lack of it. Failure (Phase 3) is a lending crisis motivated contraction in which the economy is no longer responsive to monetary stimulation. After this contraction runs its course the depression enters what we call Phase 4 or economic stagnation.

As it would take a considerable time to examine the economy's evolution to this point, it's sufficient to say that from the late forties until the July 1979 appointment of Paul Volcker the ratio of debt to GNP increased to the highest levels since the Great Depression at the same time as liquidity was severely reduced.

Since the October 1979 shift in monetary policy, the Fed, in its battle against inflation, substantially further drained liquidity. As a result, for the last three years the economy has been in a protracted liquidity crisis: interest rates have consistently held higher than at any time in the last 100 years at the same time capacity utilization has declined to the lowest level since the Great Depression.

Extended severe illiquidity inevitably causes economic failure - i.e. a lending crisis motivated contraction in which the economy ceases to be responsive to monetary stimulation. This happens when large numbers of borrowers are unable to meet their debt service obligations. This reduces both the ability and willingness of lenders to extend credit which further constricts the flow of funds to illiquid borrowers in turn causing more failures. Since the banking system is the Federal Reserve's only conduit for reliquifying the economy, if bankers are less willing to lend it follows that the Federal Reserve is less able to revive the failing economy. This signals the beginning of what we call the failure phase (Phase 3) of the depression process. The economy is now teetering on the brink of failure. Like the last months of 1979 (most recently) or the middle months of 1929 (more appropriately), the economy is now in a brief yet critically important transition period. In late 1979 the transition was from a decade of inflationary expansion to three years of liquidity crisis. In mid-1929 the transition was from a decade of extraordinarily rapid economic growth to five years of failure. The economy is now in transition from three years of liquidity crisis to a period of either failure or hyper-inflation. The economy's extremely illiquid and leveraged condition implies that a large enough injection of liquidity to avoid failure would now cause hyper-inflation (i.e. 15-18% by 1984).

Virtually all statistics reflecting the economy's rate of activity indicate it's essentially flat. This rate is consistent with capacity utilization around 70%, real GNP around $1,480 billion and the index of industrial prodution around 137.

Unfortunately, at this level of activity, a stable economy is a deteriorating economy. While it's widely assumed that an economy which is expanding is getting stronger, changes in the economy's health are not primarily a function of changes in its direction but rather of the rate at which it's operating. For example, a falling economy operating at 85% of capacity will be strengthening while a rising economy operating at 70% of capacity will be deteriorating. While the economy is now essentially flat, businesses are failing at a rate which is higher than at any time since 1933. This rate will continue to rise until capacity utilization increases to at least 78%.

Rather than thinking of the economy as homogeneous, it would be more accurate to think of it as being two-tiered with interest rate sensitive sectors on the brink of failure and non-interest rate sensitive sectors still strong. Since there is no way for the economy as a whole to remain immune to a bankruptcy crisis among the interest rate sensitive sectors, in order to assess the probability of failure it's the latter group which should be examined. While it's important to recognize that the economy as a whole is headed for failure operating at under 70% of capacity, it's even more essential to consider the implications of little or no improvement among the interest rate sensitive sectors such as autos, construction, airlines, lumber, steel, heavy equipment, etc., which are operating at less than 55% of capacity and mining companies and farmers who are selling substantially below their costs of production. In aggregate, the financial health of this large, interest rate sensitive sector of the economy is deteriorating rapidly. Its health will continue to deteriorate and failures among this sector will continue to rise unless there is an enormous reliquification. We estimate that if the economy remains flat or improves only modestly, the rate of business failures will increase by over 50% in the next six months. With the rate of business failures already unsustainably high and given the fact that it would have to decline significantly in order to avoid failure, we continue to assess the odds in favor of failure.

Since we're forecasting imminent failure while other economists are forecasting imminent recovery, obviously our understanding of how the economy works must be appreciably different from theirs. Sepcifically, our disagreement concerns liquidity.

Based on our understanding of economics, the popular forecast that the economy will turn up at the same time interest rates and inflation fall is impossible. We don't see where the increased liquidity needed to both fuel an expansion and cause interest rates to decline will come from if not from an inflationary acceleration of the money supply. The popular explanation is that when the economy turns up over the next few months it will somehow produce enough liquidity to finance the expansion and allow interest rates to decline but this increased liquidity will not show-up in accelerated, hence inflationary, money supply growth.

By contrast, our projections are based on the following three assumptions:

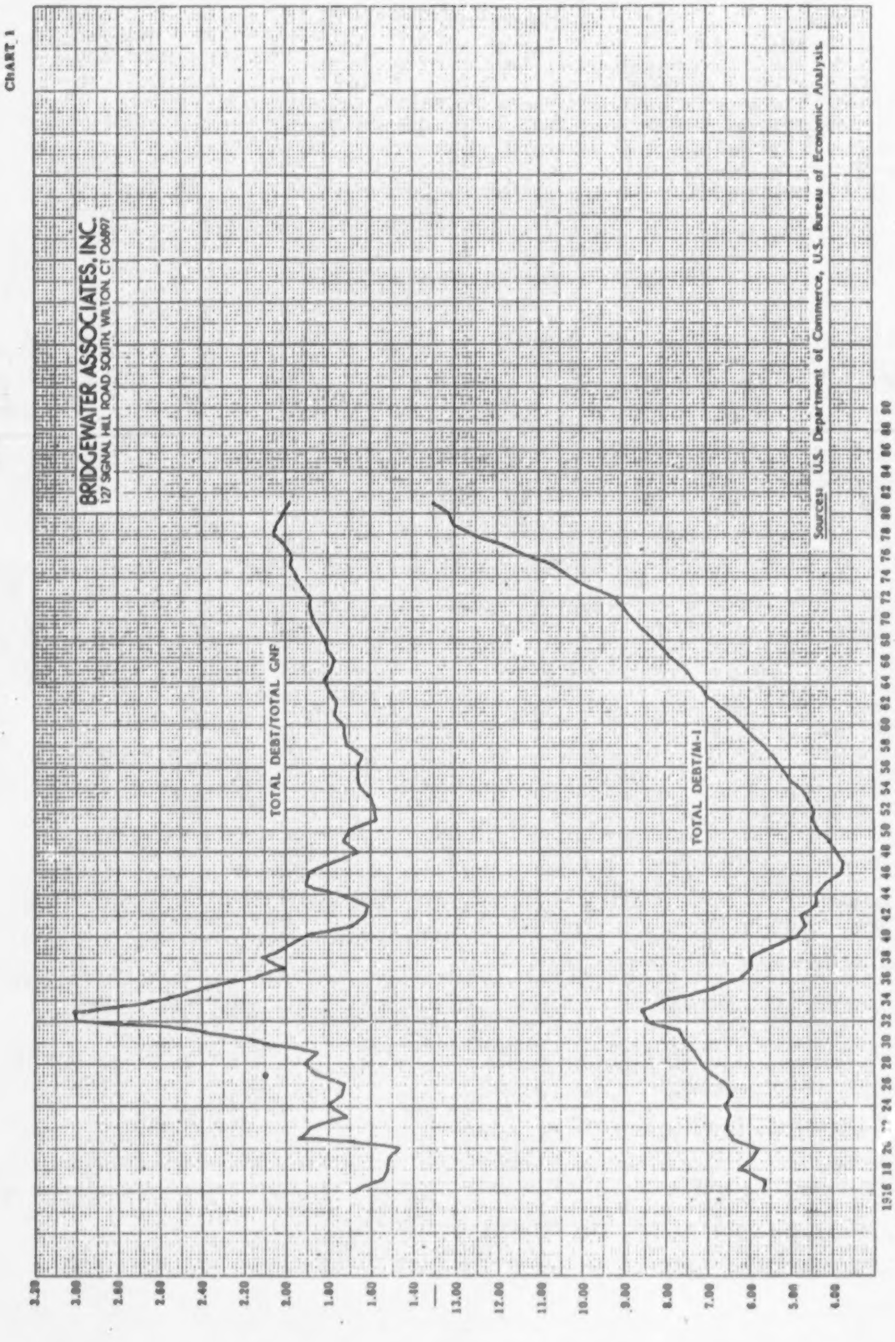
(1) Over the last three years the economy has been in a liquidity crisis - i.e. extreme illiquidity is the reason the economy is now operating at the lowest level of capacity since the Great Depression at the same time as interest rates are still (for the third consecutive year) higher than at any time in the previous 100 years.

(2) Unless there is an immediate reliquification, there can be no economic upturn accompanied by lower interest rates; as a result the rate of business failures and loan defaults will continue to rise and cause "failure" - i.e. a lending crisis motivated contraction in which the economy is unresponsive to monetary stimulation.

(3) There is no such thing as a non-inflationary reliquification - i.e. there is no way for capacity utilization to significantly increase at the same time as interest rates fall without a) the Federal Reserve flooding the banking system with liquidity, b) the banking system in turn flooding the economy with loans and c) money supply growth and inflation accelerating.

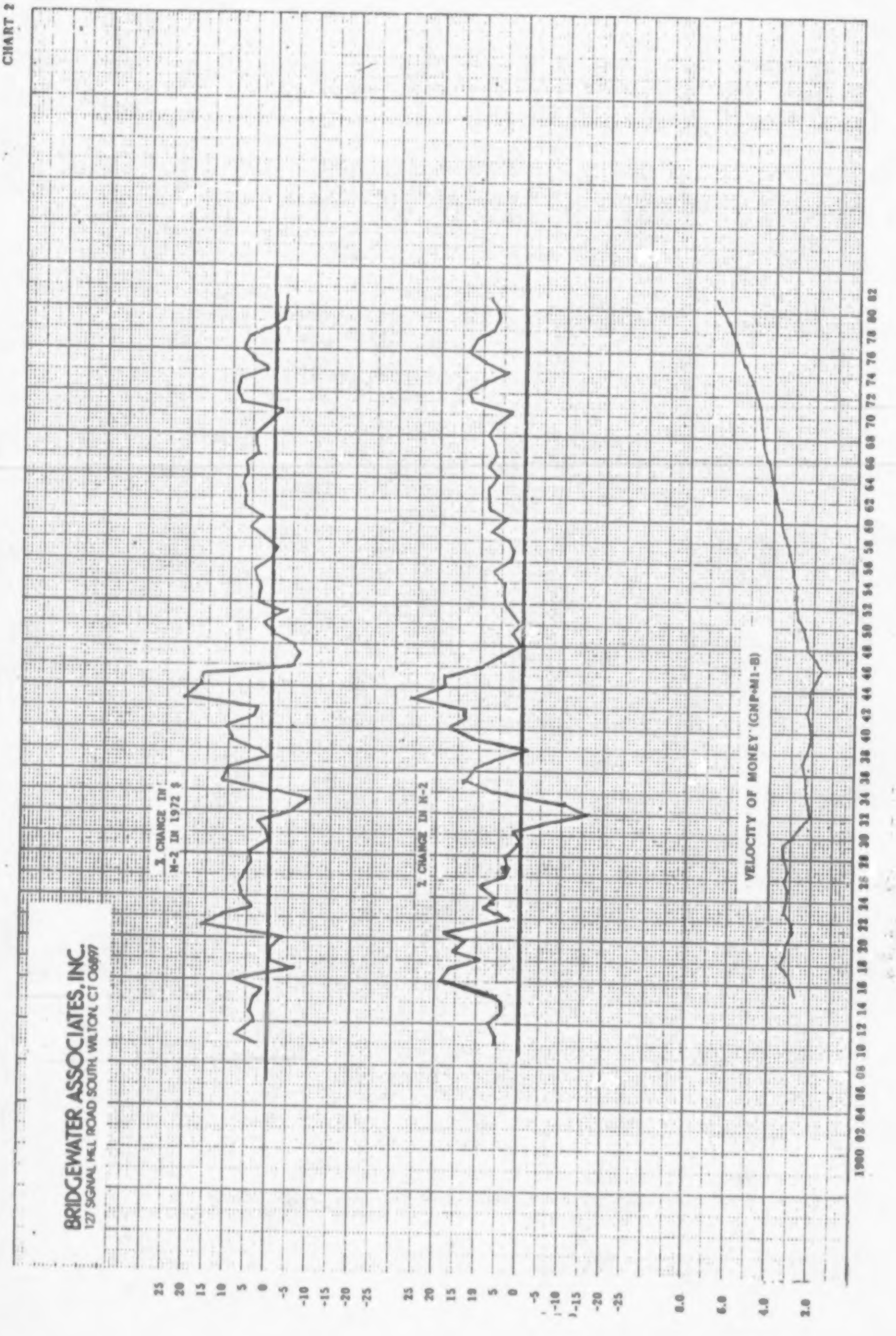
The economy is now flat, teetering on the brink of failure. The Fed, growing more concerned at this precarious position, has shifted its posture from pushing the economy toward the brink to simply watching it teeter - if it starts to go over, they'll attempt to save it and if it moves away, they'll push it right back. Where this balancing act will lead will become more apparent over the next several weeks. Although we're confident that failure and hyper-inflation are the alternatives, we're by no means certain which of these alternatives will come to pass. Whether we are headed for an extended period of failure or hyper-inflation hinges first on whether the economy responds to the Federal Reserve's stimulation and second - if it does - on whether the Fed is willing to finance monetary growth at more than double its targeted rates. Given a normal two to four month lag between stimulation and response, we'd certainly expect to know if the economy is responding within a few weeks - and, if it does, with M1, M2, M3 and L above the Fed's targets, we'd expect to see how the Fed will react shortly thereafter.

CHART 1



Sources: U.S. Department of Commerce, U.S. Bureau of Economic Analysis.

CHART 2


BRIDGEWATER ASSOCIATES, INC.
127 SIGNAL HILL ROAD SOUTH, WILTON, CT 06897
% CHANGE IN M-2 IN 1972 $
% CHANGE IN M-2
VELOCITY OF MONEY (GNP÷M1-B)
25
20
15
10
5
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-5
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-15
-20
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8.0
6.0
4.0
2.0
1900 02 04 06 08 10 12 14 16 18 20 22 24 26 28 30 32 34 36 38 40 42 44 46 48 50 52 54 56 58 60 62 64 66 68 70 72 74 76 78 80 82

CHART 3

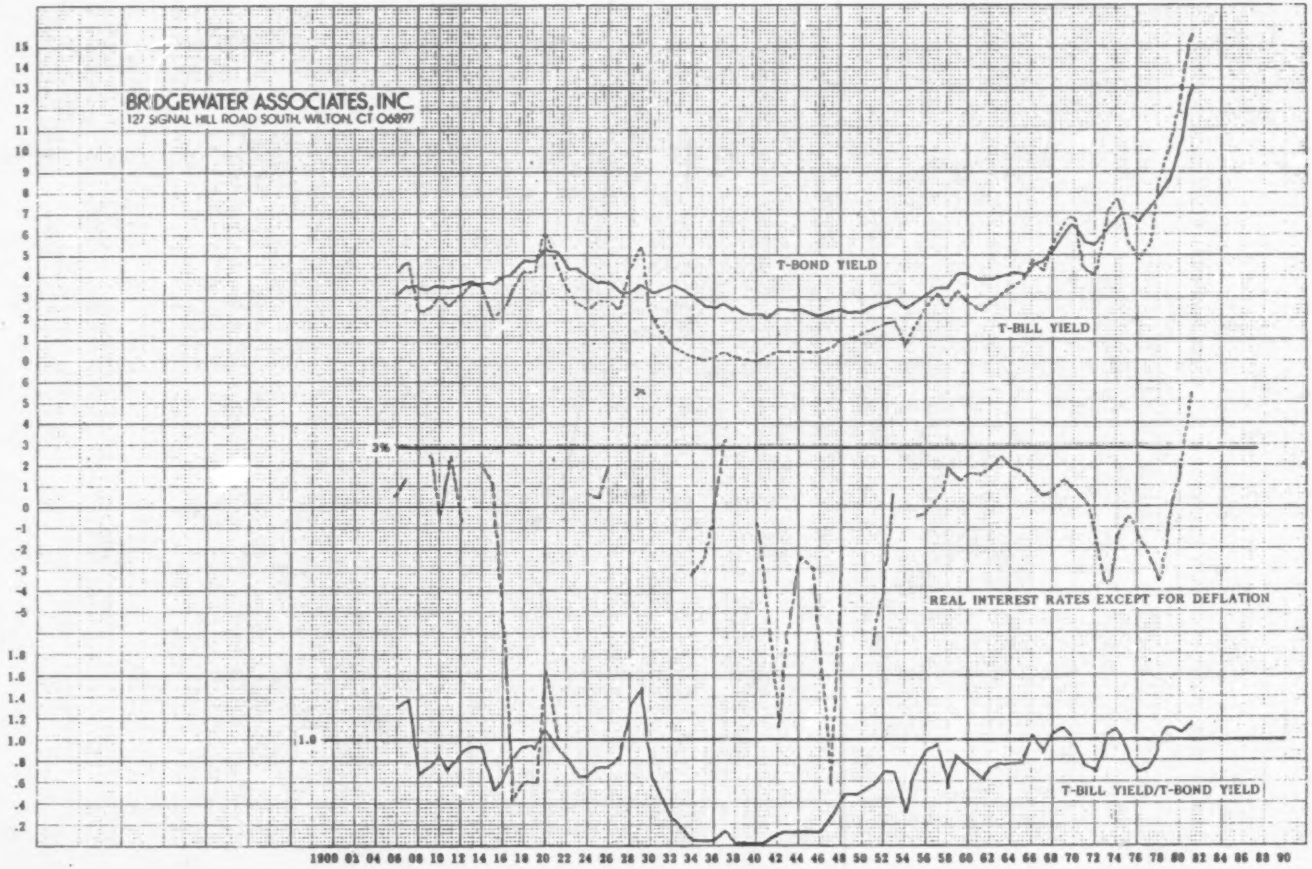
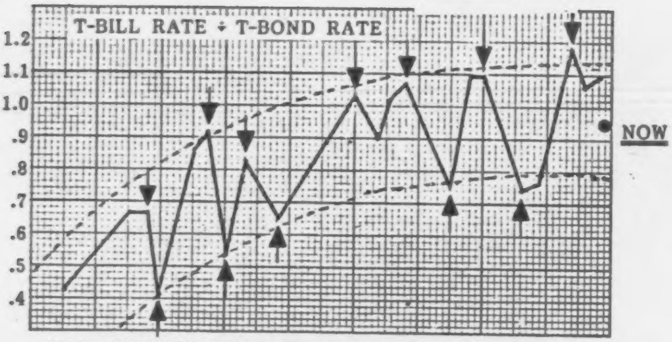

BRIDGEWATER ASSOCIATES, INC.
127 SIGNAL HILL ROAD SOUTH, WILTON, CT 06897
T-BOND YIELD
T-BILL YIELD
3%
REAL INTEREST RATES EXCEPT FOR DEFLATION
1.0
T-BILL YIELD/T-BOND YIELD
15
14
13
12
11
10
9
8
7
6
5
4
3
2
1
0
6
5
4
3
2
1
0
-1
-2
-3
-4
-5
1.8
1.6
1.4
1.2
1.0
.8
.6
.4
.2
1900 02 04 06 08 10 12 14 16 18 20 22 24 26 28 30 32 34 36 38 40 42 44 46 48 50 52 54 56 58 60 62 64 66 68 70 72 74 76 78 80 82 84 86 88 90

CHART 4



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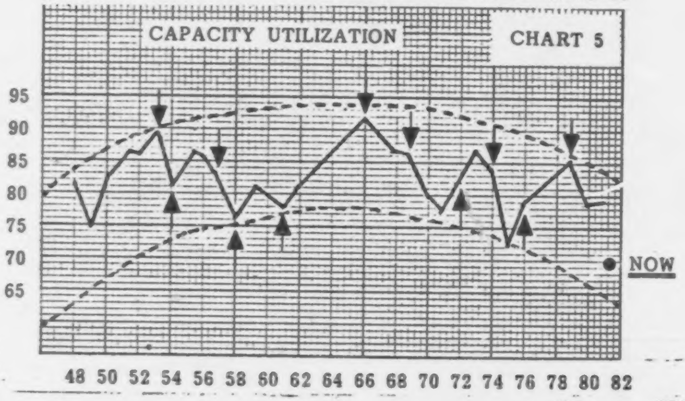

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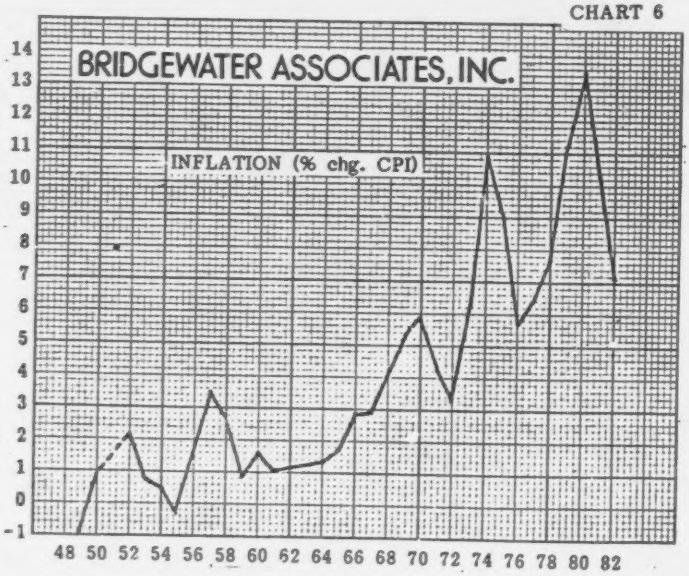
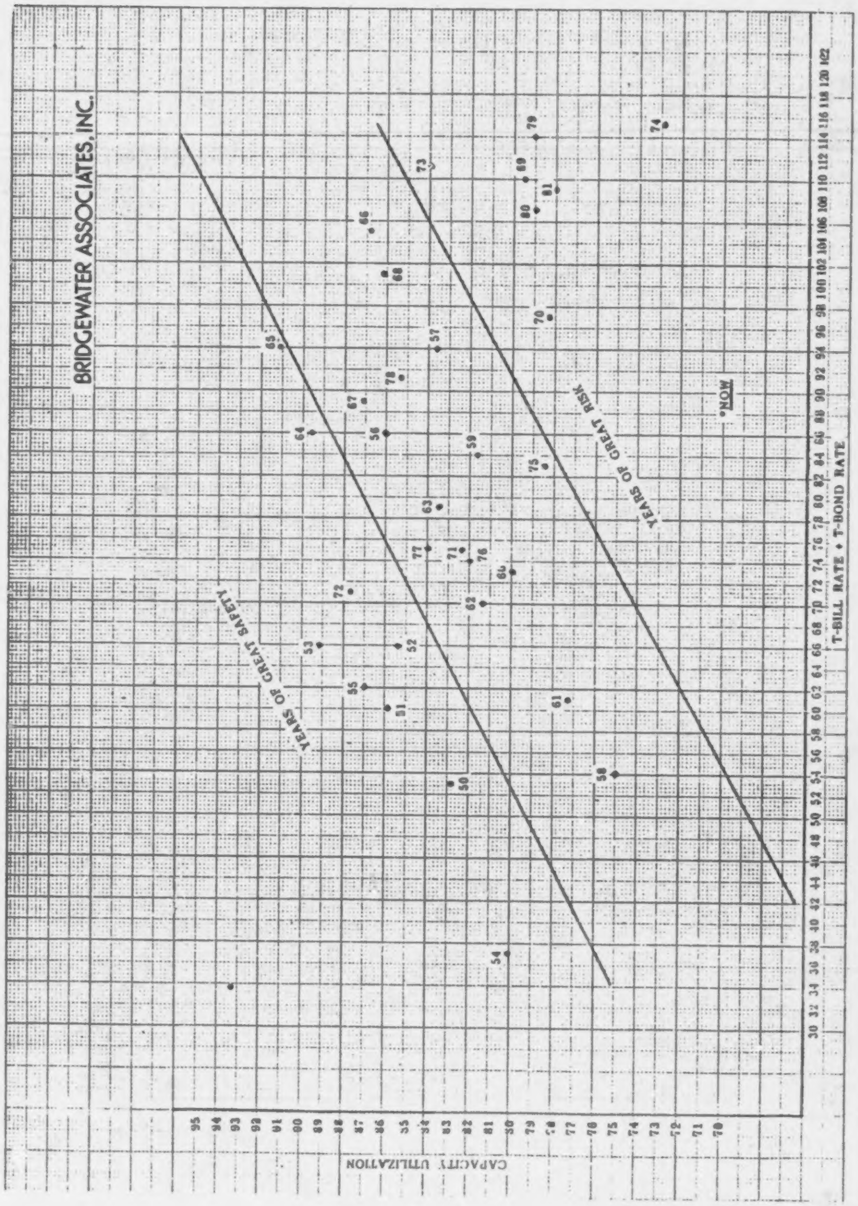


CHART 7


BRIDGEWATER ASSOCIATES, INC.
YEARS OF GREAT SAFETY
YEARS OF GREAT RISK
NOW
CAPACITY UTILIZATION
95
94
93
92
91
90
89
88
87
86
85
84
83
82
81
80
79
78
77
76
75
74
73
72
71
70
T-BILL RATE + T-BOND RATE
30
32
34
36
38
40
42
44
46
48
50
52
54
56
58
60
62
64
66
68
70
72
74
76
78
80
82
84
86
88
90
92
94
96
98
100
102
104
106
108
110
112
114
116
118
120
122
50
51
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54
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60
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62
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78
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80
81

CHART 8

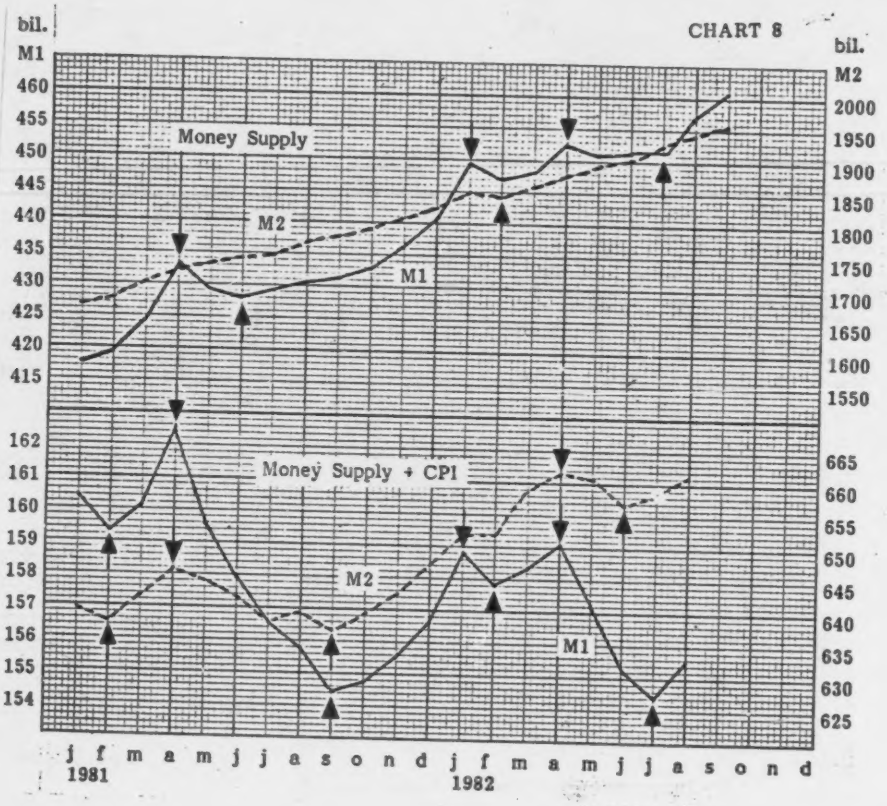
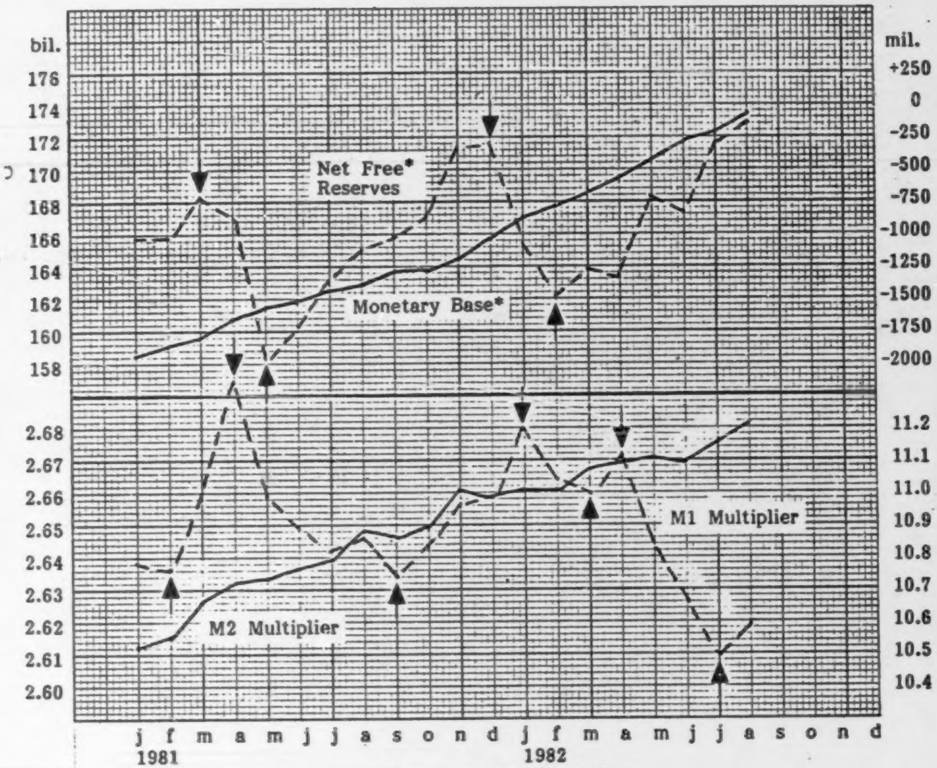

bil.
M1
460
455
450
445
440
435
430
425
420
415
bil.
M2
2000
1950
1900
1850
1800
1750
1700
1650
1600
1550
Money Supply
M2
M1
162
161
160
159
158
157
156
155
154
665
660
655
650
645
640
635
630
625
Money Supply ÷ CPI
M2
M1
j f m a m j j a s o n d j f m a m j j a s o n d
1981
1982

CHART 9



*Unadjusted for changes in reserve requirements.

CHART 10

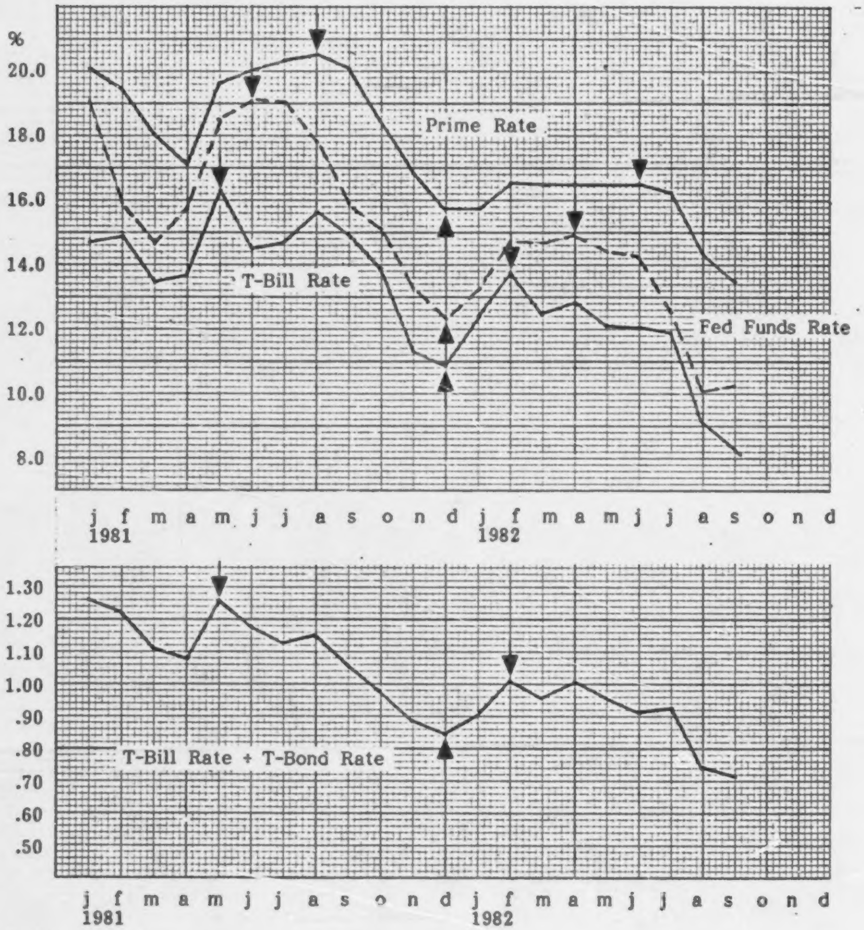
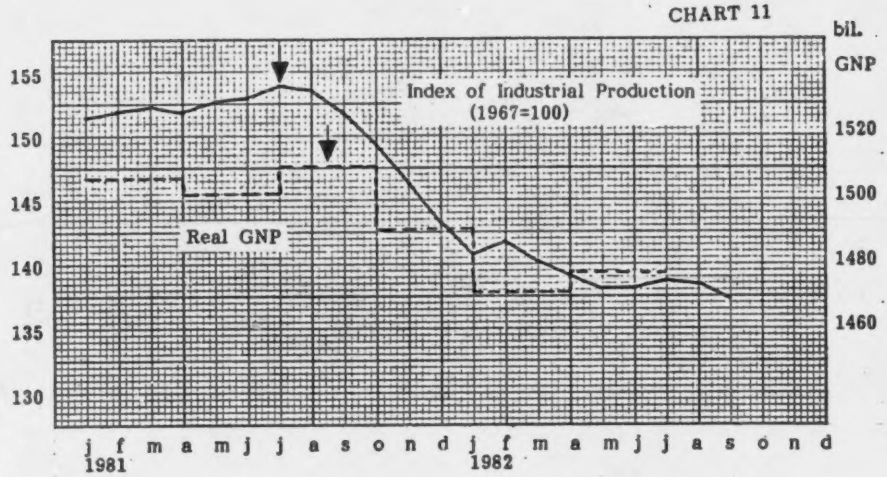

%
20.0
18.0
16.0
14.0
12.0
10.0
8.0
Prime Rate
T-Bill Rate
Fed Funds Rate
j f m a m j j a s o n d j f m a m j j a s o n d
1981
1982
1.30
1.20
1.10
1.00
.90
.80
.70
.60
.50
T-Bill Rate ÷ T-Bond Rate
j f m a m j j a s o n d j f m a m j j a s o n d
1981
1982

CHART 11



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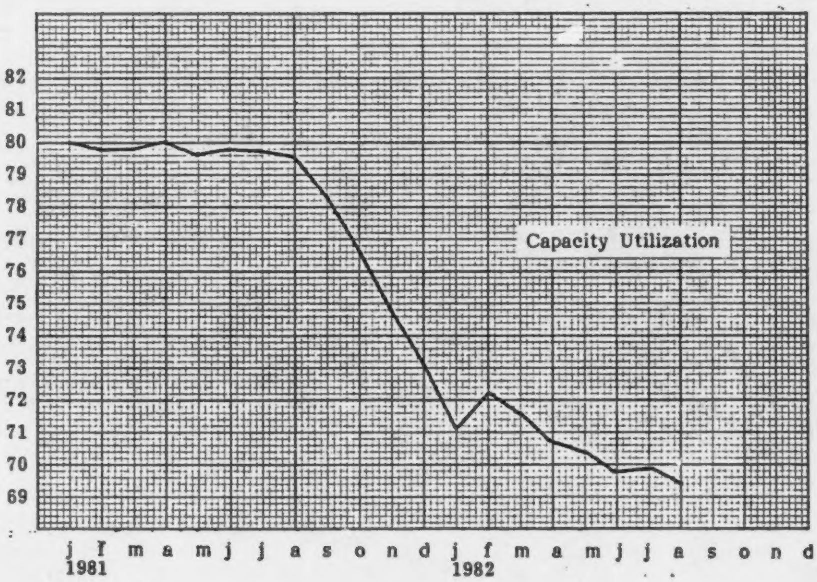


CHART 13

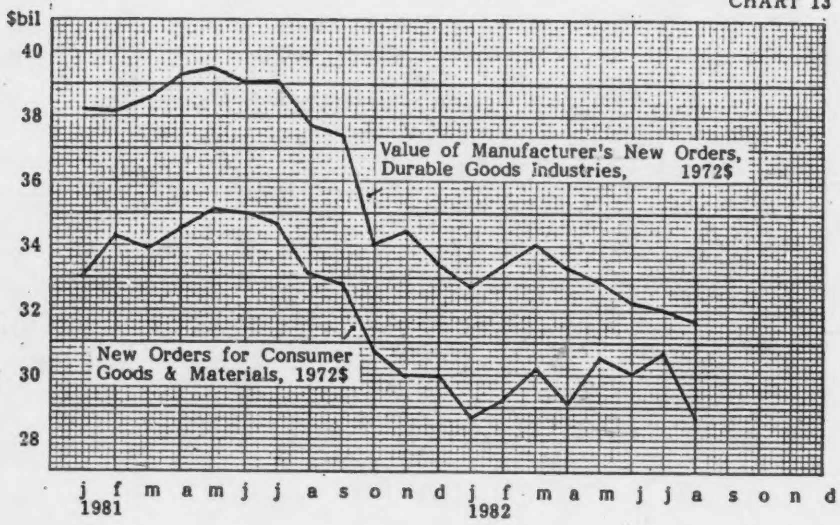


CHART 14

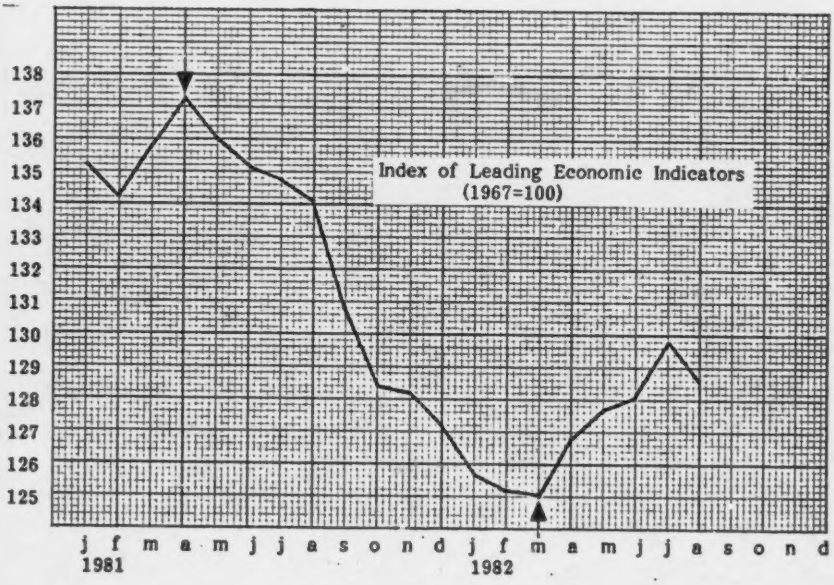


CHART 15

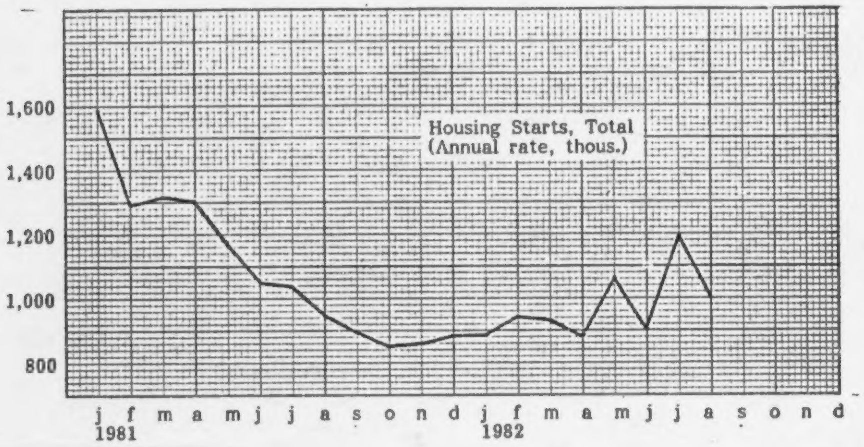


CHART 16

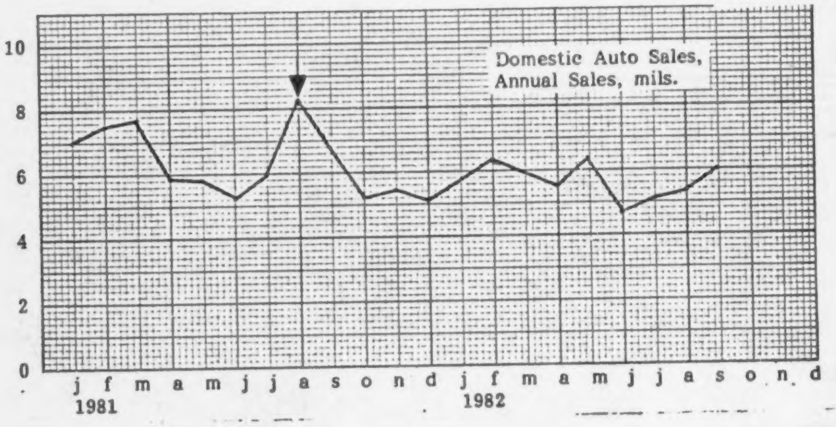


CHART 17

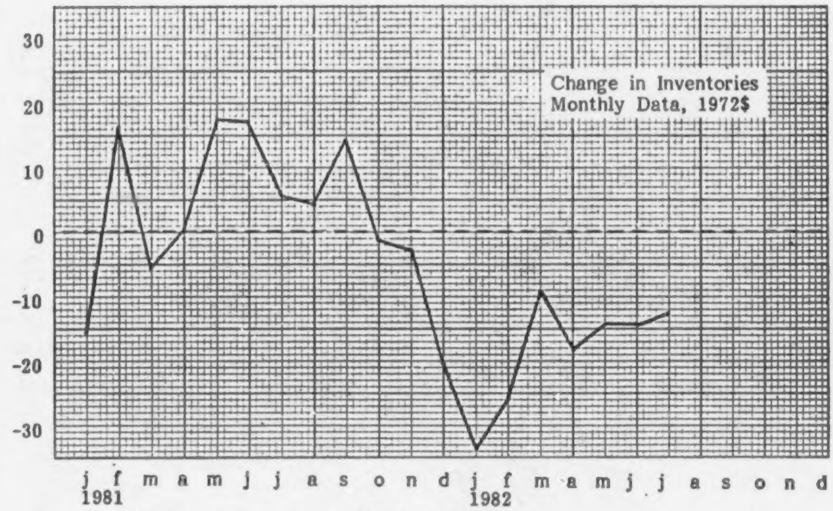


CHART 18

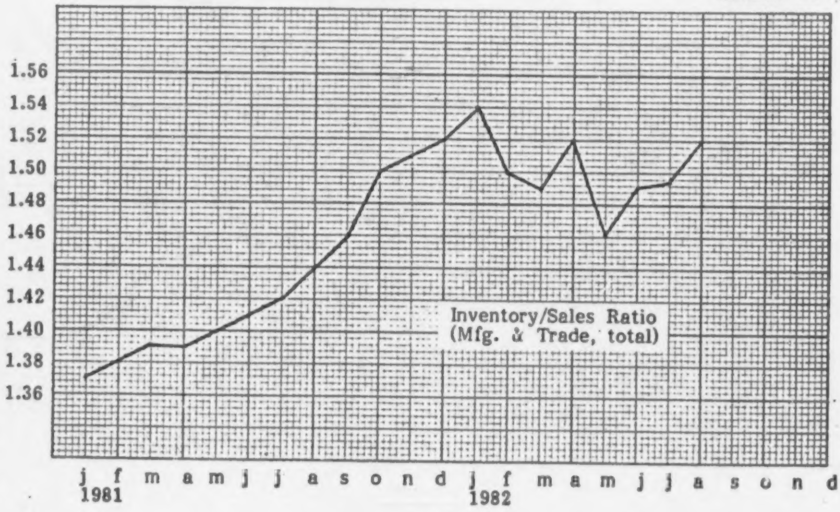


CHART 19.

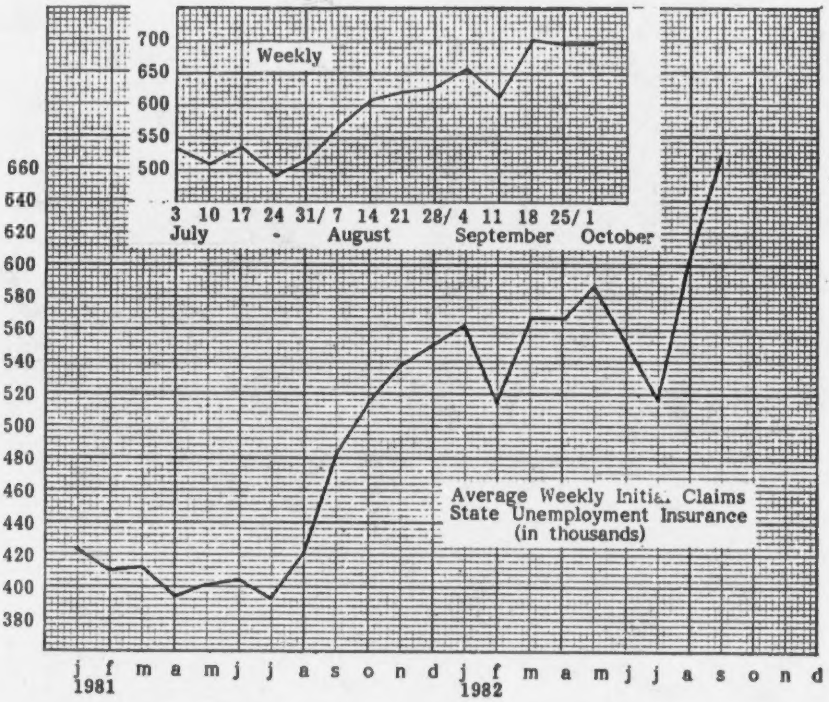

Weekly
700
650
600
550
500
3 10 17 24 31/ 7 14 21 28/ 4 11 18 25/ 1
July August September October
660
640
620
600
580
560
540
520
500
480
460
440
420
400
380
Average Weekly Initial Claims
State Unemployment Insurance
(in thousands)
j f m a m j j a s o n d j f m a m j j a s o n d
1981
1982

CHART 20

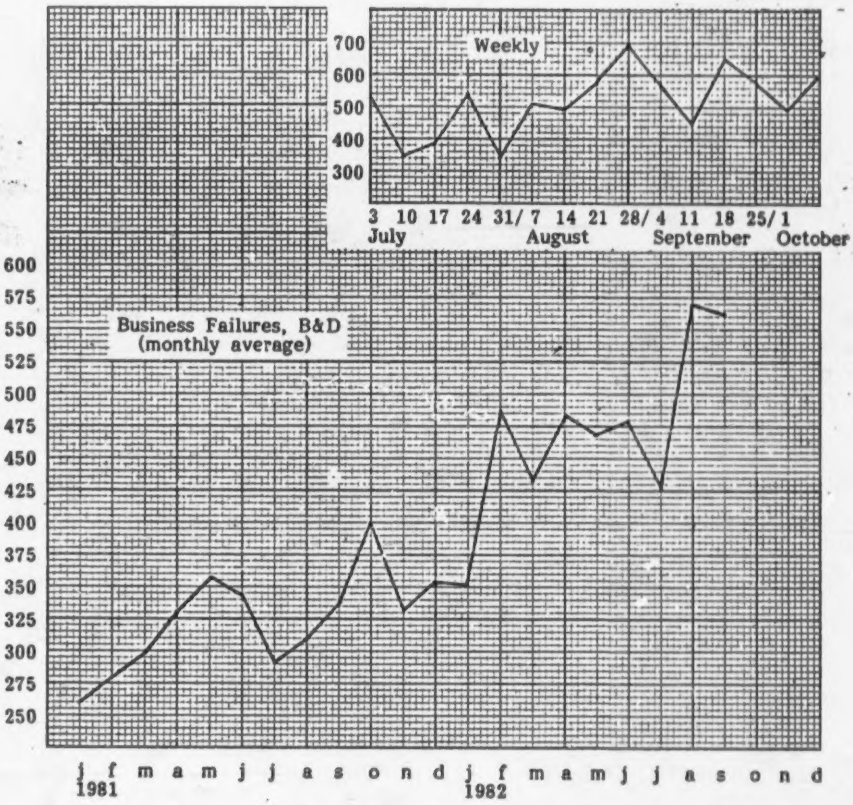

Weekly
700
600
500
400
300
3
10
17
24
31/
7
14
21
28/
4
11
18
25/
1
July
August
September
October
Business Failures, B&D
(monthly average)
600
575
550
525
500
475
450
425
400
375
350
325
300
275
250
j
f
m
a
m
j
j
a
s
o
n
d
1981
j
f
m
a
m
j
j
a
s
o
n
d
1982

CHART 21

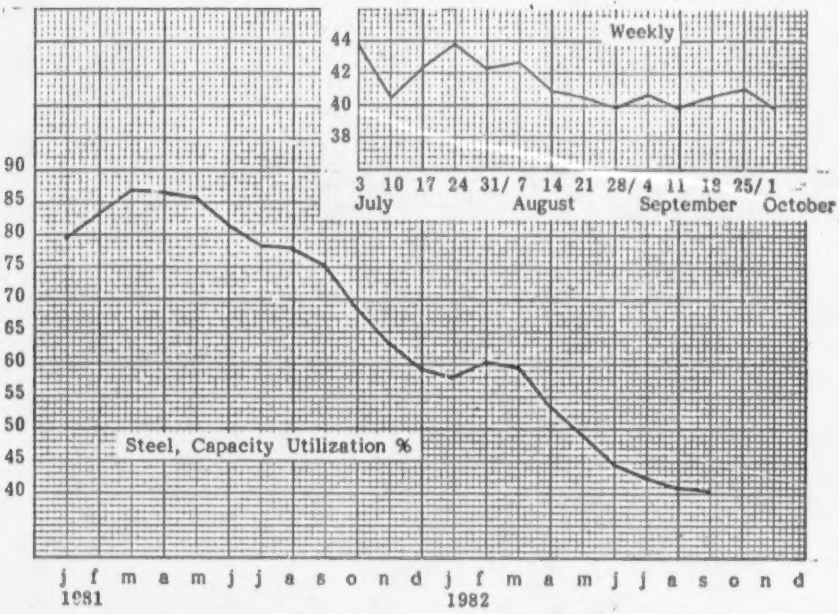


CHART 22

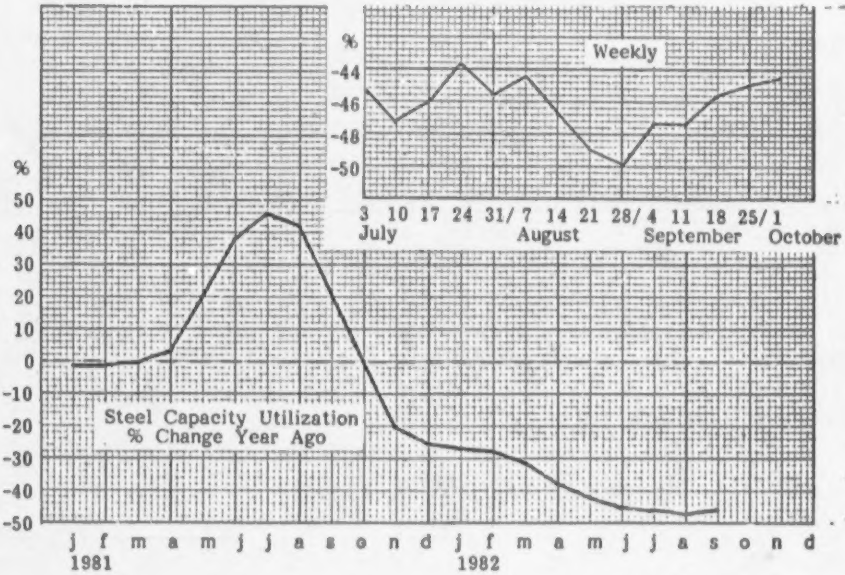


CHART 23

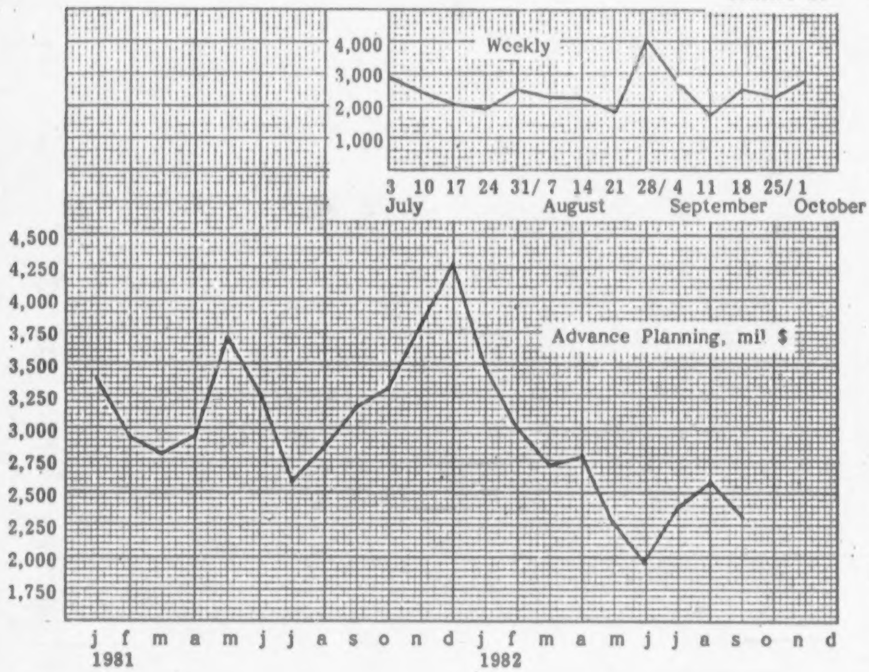


CHART 24

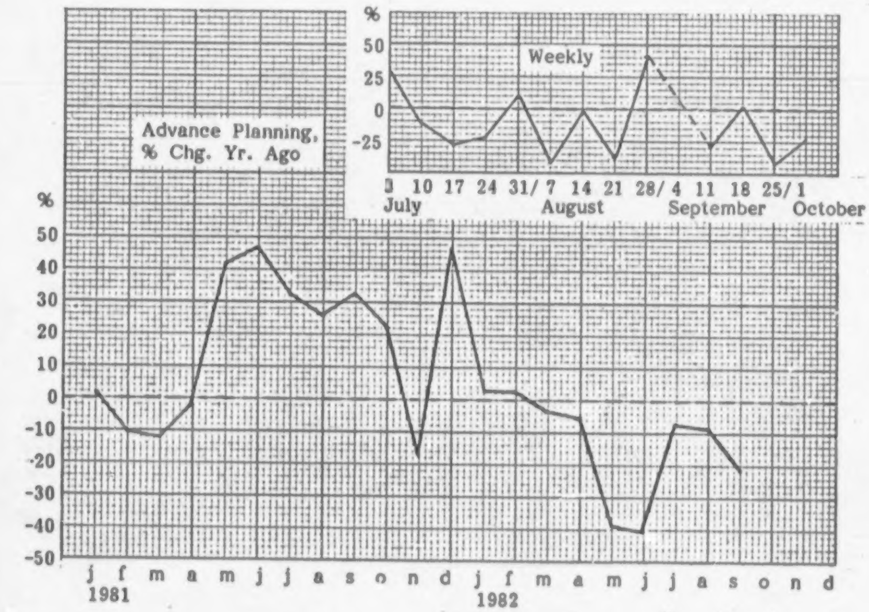


CHART 25

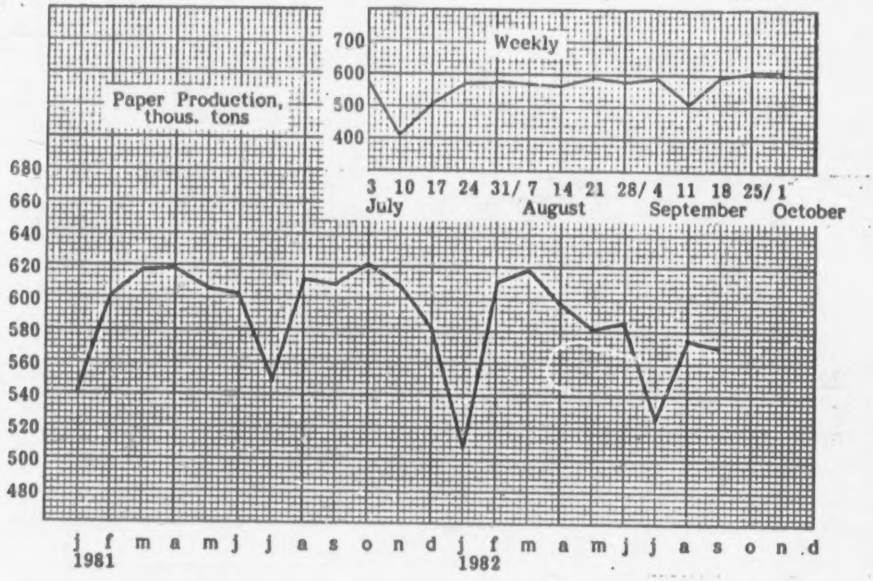


CHART 26

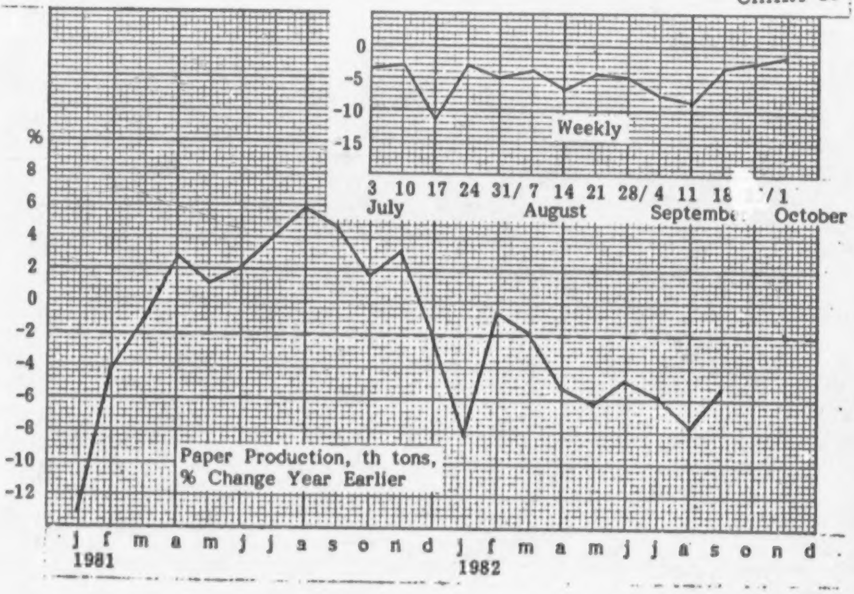


CHART 27

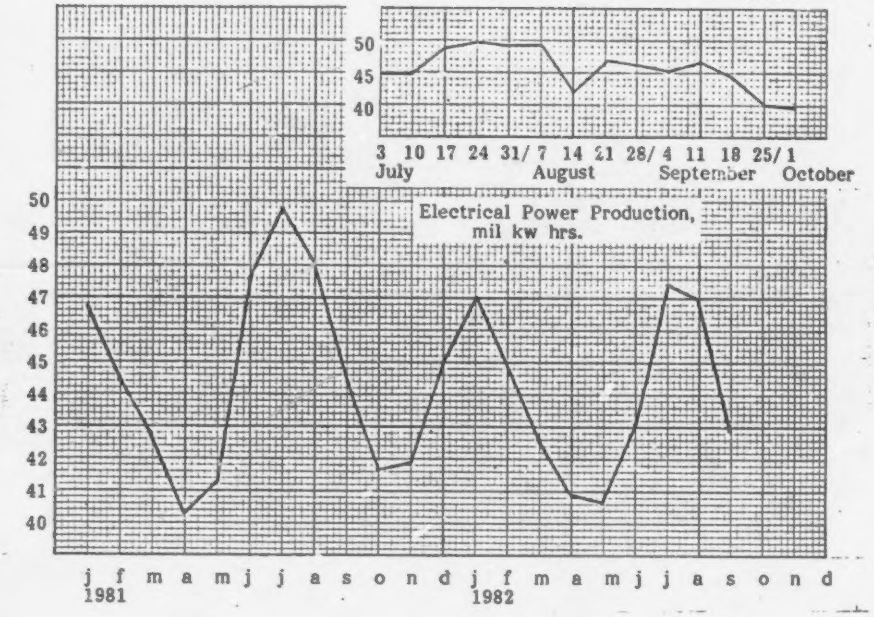


CHART 28

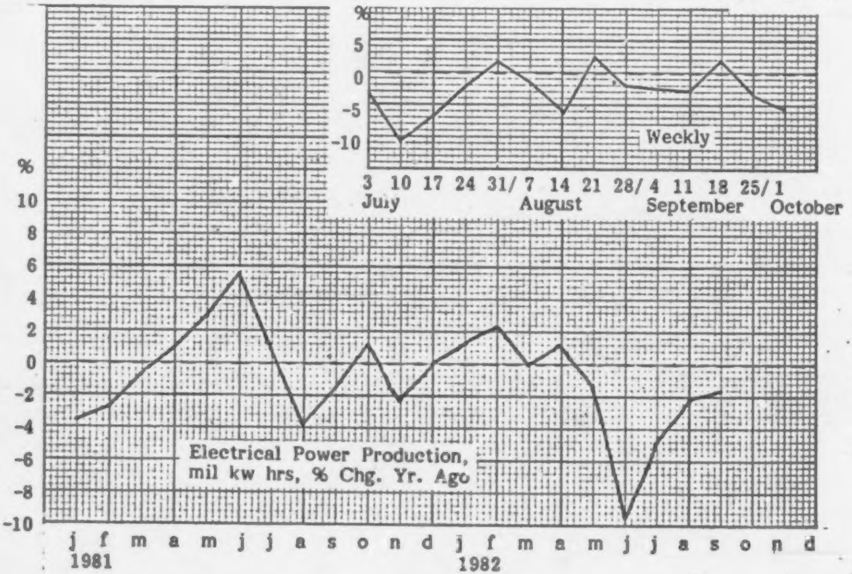


CHART 29

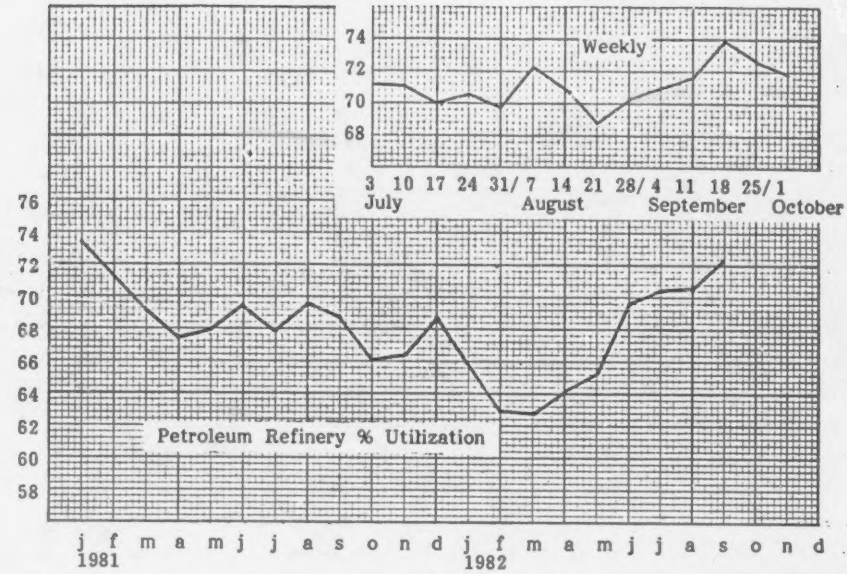


CHART 30

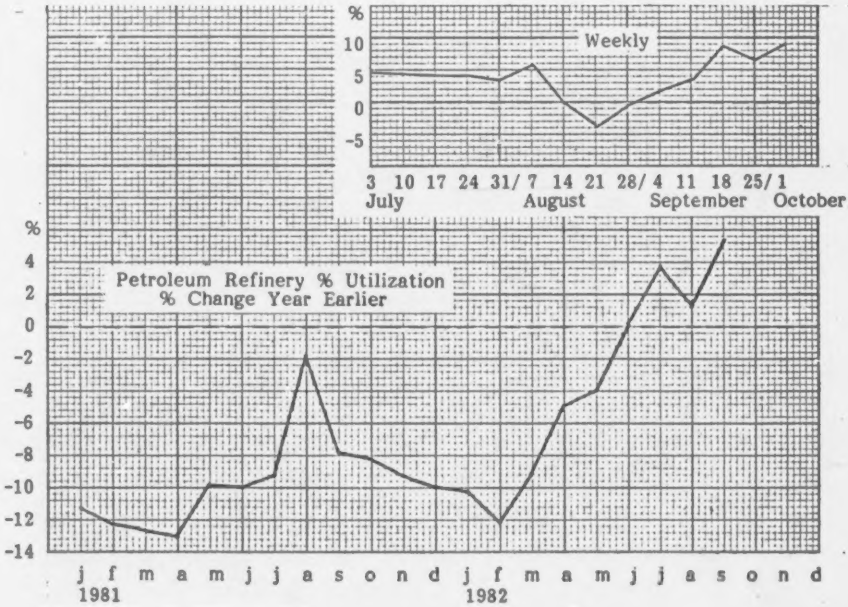


CHART 31

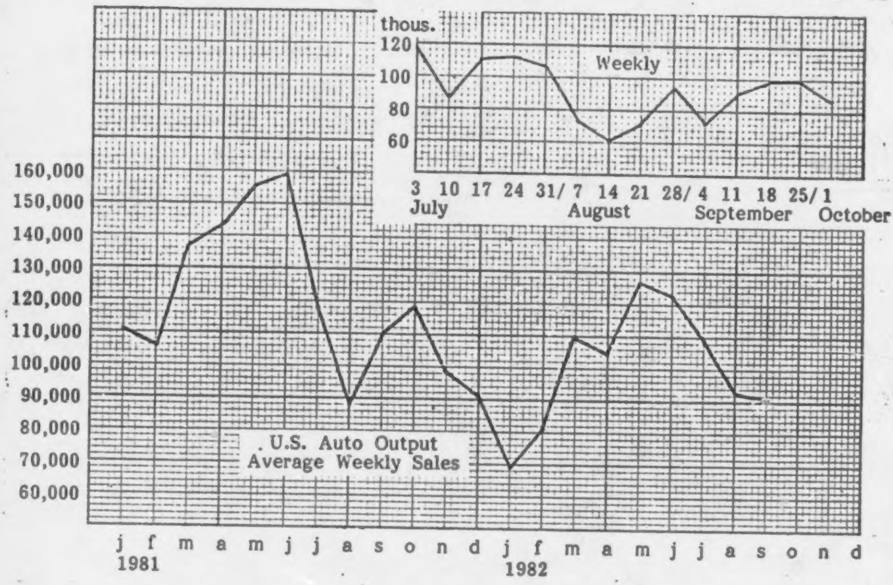
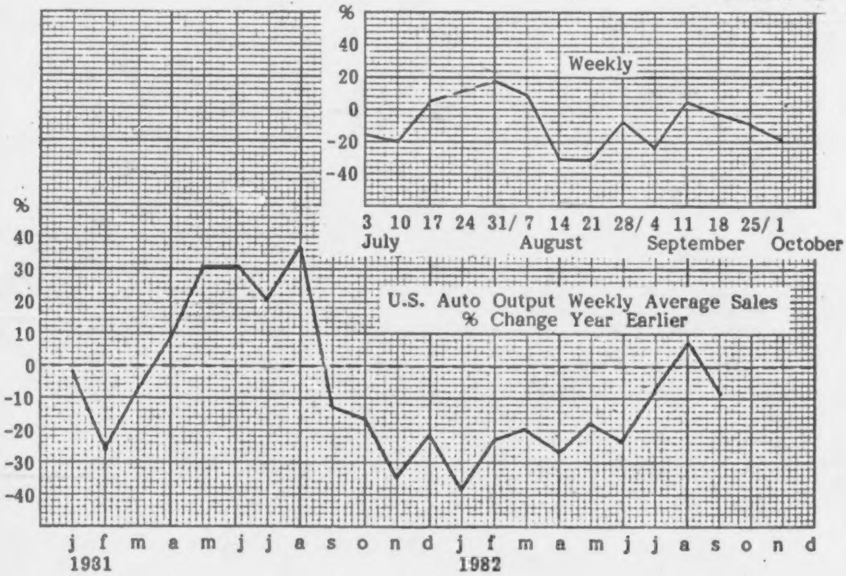


CHART 32

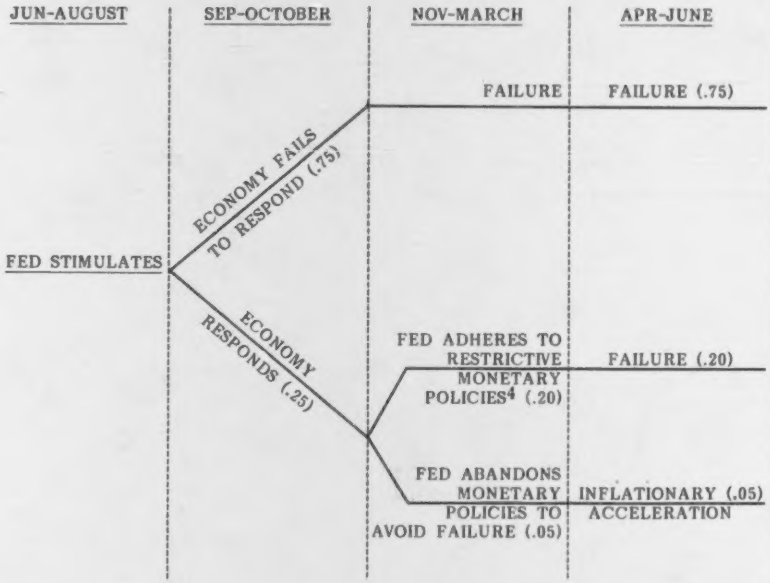


BRIDGEWATER ASSOCIATES, INC.

RELIQUIFICATION - AT THE CROSSROADS

OCTOBER 1982

In our August report we explained why the economy's extremely illiquid and leveraged condition implies that an injection of liquidity[1] large enough to prevent *economic failure*[2] would cause *hyper-inflation*[3]. Seeing no way for the Federal Reserve to steer a middle course between the inflationary expansion and disinflationary contraction alternatives, we described the economic outlook as diagramed below:


JUN-AUGUST
SEP-OCTOBER
NOV-MARCH
APR-JUNE
FED STIMULATES
ECONOMY FAILS TO RESPOND (.75)
FAILURE
FAILURE (.75)
ECONOMY RESPONDS (.25)
FED ADHERES TO RESTRICTIVE MONETARY POLICIES4 (.20)
FAILURE (.20)
FED ABANDONS MONETARY POLICIES TO AVOID FAILURE (.05)
INFLATIONARY (.05) ACCELERATION

---

[1] *We estimate this would require M1 to grow at a rate of approximately 15% and M2 to grow at around 18% for at least six months.*

[2] *A lending crisis motivated contraction in which the economy ceases to be responsive to monetary stimulation.*

[3] *15-18% inflation within eighteen months.*

[4] *By restrictive, we mean trying to roughly adhere to its targets - i.e. M1 growth around 6% and M2 growth around 9%.*

55%

Whether or not you agree with the timetable or probabilities we assigned is less important than agreeing that these are the alternatives. At the risk of oversimplifying[5], our reasoning is as follows:

(1) Over the last three years[6] the economy has been in a protracted liquidity crisis - i.e. extreme illiquidity is the reason the economy is now operating at the lowest level of capacity since the Great Depression at the same time as interest rates are still (for the third consecutive year) higher than at any time in the previous 100 years.

(2) Unless there is an immediate reliquification, there can be no economic upturn accompanied by lower interest rates; as a result the rate of business failures and loan defaults will continue to rise and cause "failure" - i.e. a lending crisis motivated contraction in which the economy is unresponsive to monetary stimulation.

(3) There is no such thing as a non-inflationary reliquification - i.e. there is no way for capacity utilization to significantly increase at the same time as interest rates fall without a) the Federal Reserve flooding the banking system with liquidity, b) the banking system in turn flooding the economy with loans and c) money supply growth and inflation accelerating.

For these reasons we concluded that the economy is "at the crossroads" - i.e. like the last months of 1979 (most recently) or the middle months of 1929 (more appropriately), the economy is now in a brief yet critically important transition period. In late 1979 the transition was from a decade of inflationary expansion (in which being in debt and owning hard assets paid) to three years of liquidity crisis (in which having liquidity and investing it in short term debt instruments was best). In mid-1929 the transition was from a decade of extraordinarily rapid economic growth (during which owning stocks was best) to five years of failure (at which time the bond market was the place to be). The economy is now in transition from three years of liquidity crisis to a period of either failure or hyper-inflation[7].

The diagram on the front page shows the economy's alternative directions through this transition period. As shown, whether we are headed for an extended period of failure or hyper-inflation hinges first on whether the economy responds to the Federal Reserve's stimulation and second - if it does - on whether the Fed is willing to finance monetary growth at more than double its targeted rates. Given a normal two to four month lag between stimulation and response, we'd certainly expect to know if the economy is responding within a few weeks - and, if it does, with M1, M2, M3 and L above the Fed's targets, we'd expect to see how the Fed will react shortly thereafter.

---

5. *For a complete explanation of the reasoning and evidence in support of these conclusions see our August report.*

6. *Since the July 1979 appointment of Paul Volcker.*

7. *Liquidity is now too reduced to allow a return to stagflation. Stagflation was the successful balancing of the high inflation, weak economy alternatives.*

STIMULATION

Since the last three years' overly restrictive Fed policies made liquidity the most important influence on the economy, the art of economic forecasting has become the art of interpreting Fed policy[8]. Particularly in light of recent developments, we think it's appropriate to begin this report with an examination of this policy.

Although "stimulative" and "restrictive" are among economists' most frequently used words, they have no agreed upon meaning. Some say the Fed is stimulative when money supply is rising while others use total reserves as their gauge. Without digressing into an examination of the relative merits of these gauges, we simply want to make our own terminology clear. When we describe the Fed as being stimulative we mean that they're pursuing a policy designed to increase net free reserves and lower interest rates, when we say they're restrictive we mean that they're trying to reduce net free reserves and raise interest rates and when we describe them as being neutral we mean they're trying to hold both net free reserves and interest rates relatively steady.

Although most people think of the Fed as having pursued a policy primarily designed to steer monetary growth in line with its stated targets, it would be more accurate to think of their policy as being to "lean against the wind" - in other words, to drain reserves and force interest rates up when money supply grows too rapidly and to add reserves and force interest rates down when money supply doesn't grow rapidly enough. Thus, as explained in past reports[9], the Fed's late spring move to stimulative policies (i.e. policies designed to increase net free reserves and lower interest rates) was easy to call[10] simply because it was in response both to money supply falling and the world economy tipping over the brink[11]; hence it was perfectly in keeping with their policy of "leaning against the wind".

---

8. *Probably the largest single cause of interest rate volatility is uncertainty over Fed policy. This is particularly true since, rather than explaining exactly what the Fed's policies are, Chairman Volcker has added a dimension of intrigue by leaving it to us to interpret innuendos and uncover leaks. Statements such as "interest rate declines of recent weeks reflect a consistent deflationary monetary policy and confidence in the future inflation outlook rather than a new decision to ease tight money" are designed to camouflage what's really happening rather than to enhance the public's understanding.*

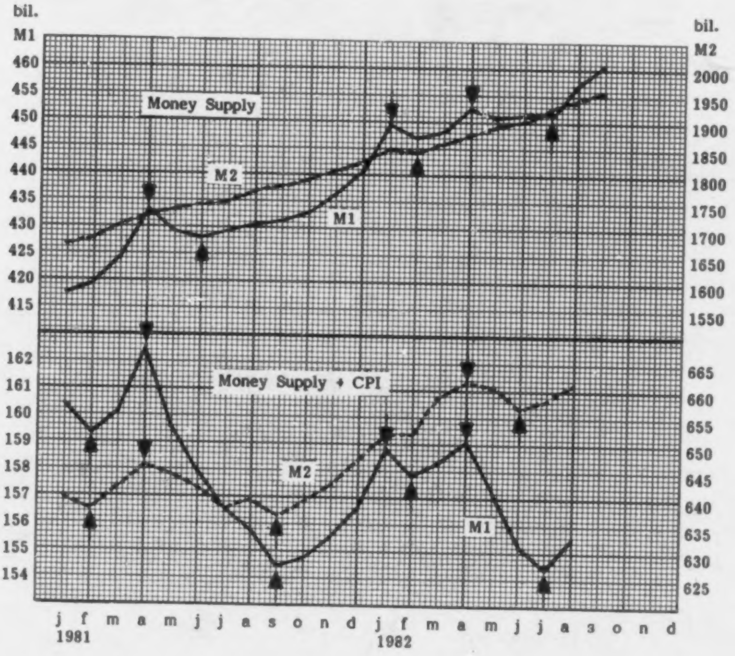
9. *For a more detailed explanation of the Federal Reserve's stimulative policies, see our June and August reports.*

10. *It's when some gauges point in favor of loosening while others point in favor of tightening that one's understanding of the Fed is put to the test.*

11. *There is virtually no evidence in support of the popular theory that pre-election politics were the primary cause of the Fed's turning stimulative. This interest rate decline is reminiscent of the II Q 80 decline which resulted from that quarter's 9.9% tumble in real GNP with M1 and M2 both falling, but was popularly misinterpreted as pre-election hype.*

All the gauges which the Fed has used to set its reserve and interest rate targets then pointed in favor of turning stimulative. Observe how in April-July real and nominal M1 and real M2 fell sharply (see Chart 1) and how the decline in M1 came almost entirely as the result of a sharp fall in the multiplier[12] (see Chart 2). With the failure rate high (see Chart 13) and the economy weakening (see Charts 4-6) the Fed's shift to stimulative policies was a fait accompli. Net free reserves were in turn forced up (see Chart 2) and interest rates were forced down (see Chart 3) - at least until this stimulation created a response.

CHART 1 - MONEY SUPPLY



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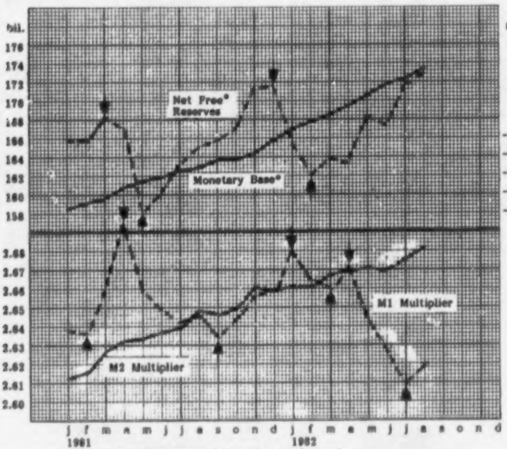
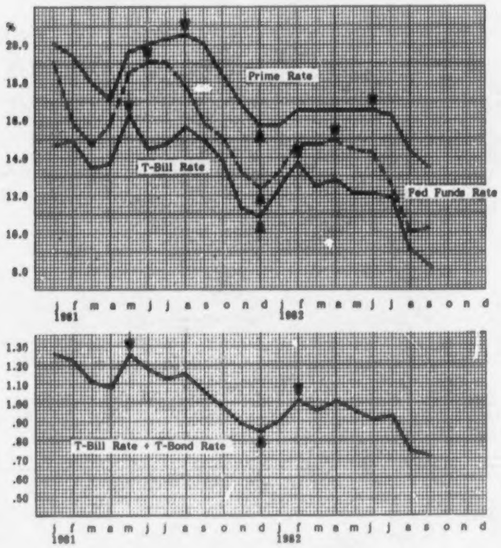
[12] *The falling M1 multiplier signified that the decline in money supply was more demand motivated than a response to a shortage of reserves.*

CHART 2 - RESERVES



*Unadjusted for changes in reserve requirements.

CHART 3 - INTEREST RATES



Then, in August and September, real and nominal M1 jumped sharply and the economy exhibited some signs of response thus raising the question of whether the Fed would adhere to or abandon its policies. At this point two policies were called into question - the widely followed policy of trying to adhere to its targets and the more fundamental policy of "leaning against the wind". While it's been clear for over six months that the Fed would accommodate growth in excess of their targets[13], it's still not clear to what extent they're willing to abandon their policy of "leaning against the wind" and instead "lean into the wind" (i.e. add reserves and push interest rates lower while money supply is accelerating) in order to assure a recovery.

In reaction to the sharp upturn in M1 in August-September the Fed turned from stimulative to neutral - i.e. in contrast to the July-August period when interest rates fell and net free reserves were steadily increased (to nearly plus $100 million), in the September to early October period Fed funds were held at a shade over 10% and reserves were added and drained strictly with the objective of adhering to this interest rate target (as a result net free reserves swung wildly, averaging minus $300 million throughout this period).

This shift to a neutral policy was exactly what one would have expected on the basis of the Fed's past behavior. Unable to turn restrictive for fear of eliminating any prospect for recovery, they also feared that by remaining stimulative they might spark too strong a response which would cause money supply to explode (leaving them faced with the unpleasant alternative of forcing interest rates sharply higher or feeding an inflationary monetary explosion). Walking a tightrope, they decided to wait and sense the direction of the next gust of wind before leaning one way or the other. If this hesitation to remain stimulative eventually proves to be the economy's kiss of death, the Administration must, to some extent, also be held culpable. At the end of September the Treasury was in total agreement with this policy. Speaking of the Fed's handling of monetary policy Treasury Secretary Regan said, "I don't think they have to loosen it any more to be able to sustain this recovery." On the other hand, he made clear that he didn't want them to turn restrictive by saying, "Were they to tighten it, they would choke off the recovery." In other words, the Treasury and the Fed were then in complete agreement that a neutral monetary policy was appropriate, once again making the tragic error of putting too much emphasis on accelerating money supply relative to falling velocity. As we'll see in the next section of this report, only the most anemic signs of the economy responding to the Fed's stimulation were apparent, while signs of failure were also increasing.

Then, during the first week of October, there were signs that the Fed might shift from neutral to stimulative. First, several disappointing statistics surfaced. For example, industrial production, factory orders, the index of leading indicators and a whole host of other indices fell while initial claims for unemployment shot up. Growth of the monetary base began to slow and the M1 multiplier started to fall. Concerns about country defaults increased in response to Mexican President Portillo's speech to the U.N. and Argentina not paying its debts. European bankers openly talked of an impending Eurodollar crisis.

---

13. We concluded our May report by saying, "While the Fed is stubborn, we do not believe that they are as uncompromising as they maintain. We have no doubt that the Fed's governors now realize that their targets are set unrealistically low (surely they can't be planning to hold M1's growth to around 2.3% through the rest of the year). Over the next several months the pressure to ease will also increase to unprecedented levels. Therefore, we expect them to accommodate growth in excess of their targets, but not nearly enough."

Treasury Secretary Reagan, in his October 6th speech to members of the Dealer Bankers' Association, intended to allay growing fears of a financial crisis by saying that although U.S. banks face six months to a year of "serious problems", they can depend on help from the government if debtor nations default. He explained that "All these problems one by one can be handled and are manageable" but "collectively, they present quite a risk." If the banks have financial problems "caused by outside pressures... and we can be helpful, I think it is up to the government both through the Central Bank as well as the through the Treasury to be helpful." He added, "It came on very unexpectedly, much deeper than any economist had forecast and it's going to last longer than most economists forecast."[14] The stock and bond markets in turn shot up in reaction to growing prospects of reliquification. On October 7th, the FOMC held a policy setting meeting and indicated that they would accommodate money supply growth in excess of their targets. While Paul Volcker would make a better poker player than Donald Regan, it was clear that he was concerned when he said, "The forces are there that would push the economy toward recovery. I would think that the policy objective should be to sustain recovery."

Exactly what this means is not yet apparent. It can be interpreted that the Fed will not turn restrictive in order to bring money supply within its targeted range or, more significantly, it can mean that they will turn as stimulative as necessary in order to bring about a recovery. Since there are various degrees of being stimulative, we will watch with great interest to see whether the October 1982 shift in Fed policy will have the same significance as the October 1979[15] shift.

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14. The greatest tragedy is that all this could have been prevented. The blame rests squarely on the shoulders of those economists in and outside of government who influence policy yet don't have a truly sound grasp of how the economy works. How could competent economists have so misunderstood the implications of these tight money policies? Consider that, eighteen months ago, they all forecast uninterrupted economic growth through 1985. For example, in July 1981, in the face of real interest rates being the highest since 1929, the President's Council of Economic Advisors forecast real growth in 1982 of 3.6%. The projections of most private economists were equally off base. For example, Allen Sinai of Data Resources forecast the 1982 economy to grow by 3.5%, Albert H. Cox of Merrill Lynch and George McKinney of Irving Trust forecast it to grow by around 4%, Wharton Econometrics and Townsend Greenspan were both a shade less optimistic and Evans Econometrics was a bit more optimistic. In other words, the consensus then forecast 1982's economic growth at around 3.5%. There were no surprises such as war, drought or an oil crisis to throw off their projections. These problems were purely the result of the Fed's overly restrictive policies and the primary reason that these policies were overly restrictive was that most economists influencing policy simply didn't understand the implications of these targets.

15. If one were to judge simply by the Fed's open market activities and half point discount rate cut last week, it would appear that they had shifted from neutral to only modestly stimulative and, as said openly by Chairman Volcker and Governor Wallach, does not signify a major policy shift.

RESPONSE

As a result of the Fed's earlier stimulation, all the classic ingredients for economic recovery are now in place. Most importantly, the banking system is flush with liquidity (encouraging bankers to increase their lending at lower rates) and capacity utilization is extremely low (making it both economical and possible to increase production). Ordinarily, one would expect that falling interest rates would free pentup demand for interest rate sensitive items[16] and slow the rate of inventory liquidation[17] and that these influences would spark a response which, if properly financed through rapid growth in the money supply, would develop into an inflationary expansion[18]. Since the last time the economy failed to respond to stimulation was over fifty years ago, it's not unreasonable to expect that it will once again[19]. On the other hand, since it's impossible for the economy to sustain a recovery unless it's reliquified and reliquification requires 1) banks to increase their lending to riskier borrowers and 2) the Fed to pump reserves into the banking system at a rate which would fuel money supply growth at more than double its targeted rate, there's reason to fear that this time the economy will not respond. The only thing that can be said for certain is that the Fed has administered a strong stimulant[20] and we'll have to wait and see if the economy responds.

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16. Most obviously, real estate, durables and storable commodities.

17. The economy is stimulated when the rate of inventory liquidation slows - not at the point when inventories are being rebuilt. For example, consider the clothing store that has an inventory of 300 suits selling at a rate of 50 per month and wants to reduce its inventory by 10%. The store would buy 20 suits, sell 50 and in turn cut its inventory by 30 (i.e. 10% of 300). Now let's suppose the store owner wanted to cut his inventory by 5%. He would buy 35 suits, sell 50 and cut his inventory by 15 suits (i.e. 5% of 300). Although he increased his order by 75% (from 20 to 35 suits), he is still reducing his inventory, but at a slower rate. In response to his ordering more suits, the suit manufacturer will increase his workers' hours and, if enough other stores increase theirs, the manufacturer will hire some of the unemployed.

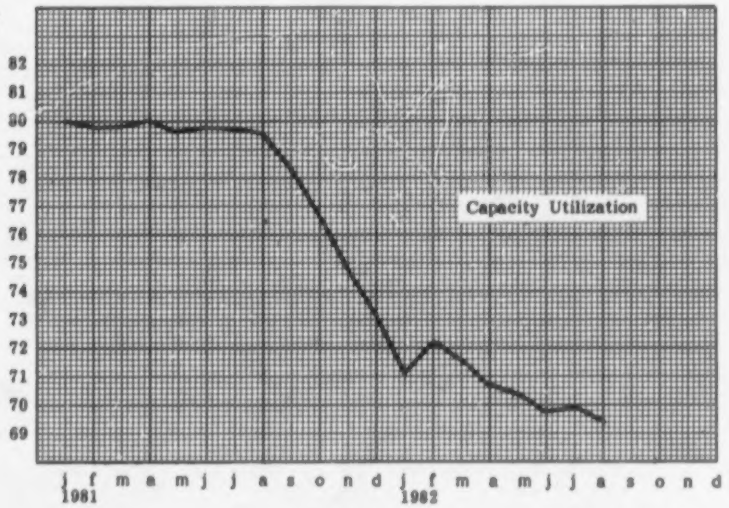
18. We find "the consumer recovery" scenario (like the "we can dispose of inflation and high interest rates without disposing of the economy" scenario) an illusory product of wishing rather than a well thought out expectation. Any student of the business cycle knows that increasing retail sales never lead the economy out of a contraction - they improve roughly coincidentally with the expansion.

19. An additional reason for optimism could be that with most loans on a variable rate basis, recent interest rate declines will ease the financial strain of leveraged companies and governments. Additionally, refinancings will be helped. For example, corporate bond issues rose to $4.4 billion in August, up from $2.9 billion in July (although in September the rate once again fell). This should help relieve the corporate demand for bank credit.

20. i.e. lower interest rates and increasing net free reserves.

Virtually all statistics reflecting the economy's rate of activity indicate it's essentially flat[21]. As shown in Charts 4-6, this rate is consistent with capacity utilization around 70%, real GNP around $1,480 billion, the index of industrial production around 137, durable goods orders around $32 billion and consumer goods orders around $29 billion. While the economy as a whole is flat[22], there are increasing signs of both response and failure.

CHART 4 - CAPACITY UTILIZATION



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[21] As indicated on the front page diagram of this transition period, we believe that whether or not the economy responds will be reflected in its behavior during the September-October period. However, since most statistics for October won't be released until November, not until then will all the facts be available.

[22] To be more precise, over the last few months it has been expanding at an annualized rate of 1-2% which is statistically insignificant.

CHART 5 - INDUSTRIAL PRODUCTION AND REAL GNP

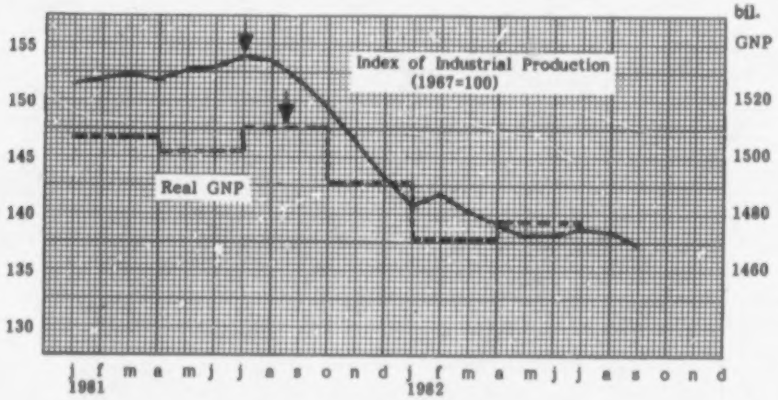
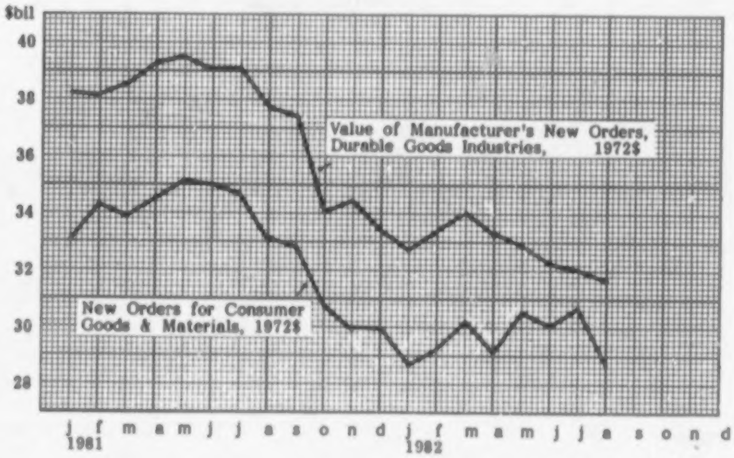
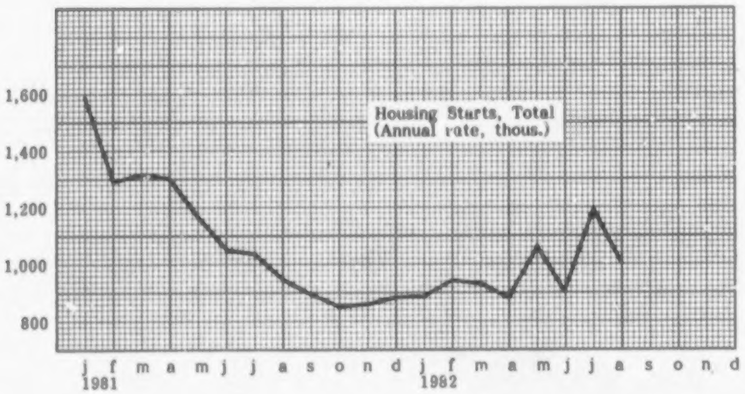


CHART 6 - NEW ORDERS FOR CONSUMER AND DURABLE GOODS



As one might hope, the demand for interest rate sensitive items such as housing (see Chart 7) and autos (see Chart 8) has firmed, albeit modestly, and the rate of inventory liquidation has been slowing (see Chart 9). Similarly, increases in the index of leading economic indicators (see Chart 10), money supply (see Chart 1) and a whole host of other weekly indices[23] have stopped falling and over the past two months have turned modestly higher. While to some extent the increases in housing starts, auto sales, the index of leading economic indicators and money supply overstate the magnitude[24], all things considered, they reflect an anemic response.

CHART 7 - HOUSING STARTS



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[23] See charts at back of report.

[24] For example, the July jump in housing starts was attributable to increasing federally subsidized apartment construction (as will the September increase which we're projecting). The September jump in auto sales was boosted by promotions designed to help move dealer inventories in order to make room for new models and slipped to 5.4 million annualized rate in early October. Like the housing and auto figures, when one examines the composition of the index of leading indicators the improvement is far less significant than it would first appear. For example, the average work week, average initial claims for unemployment, new orders for consumer goods, vendor performance, net business formation and contracts for plant and equipment all show little or no improvement. The index was boosted primarily because of increases in building permits, a declining rate of inventory liquidation (both explained above), a sharp jump in stock prices (explained in the appendix to this report) and a significant increase in sensitive crude materials prices (more a harbinger of increasing inflation than of an expanding economy). Similarly, the increasing money supply overstates the economic response as the velocity continues to decline and much of the growth is directly attributable to high debt service payments.

CHART 8 - DOMESTIC AUTO SALES

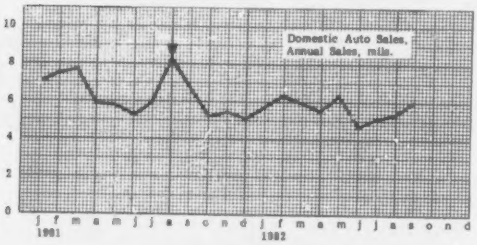


CHART 9 - CHANGE IN INVENTORIES

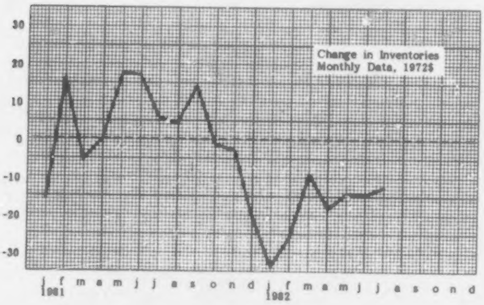
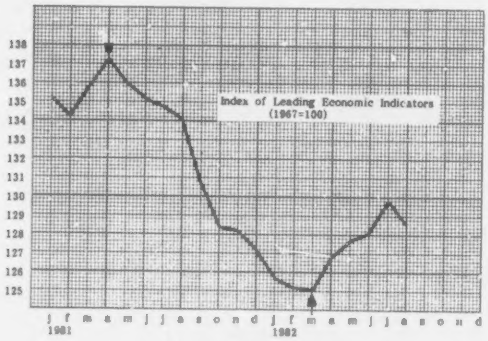
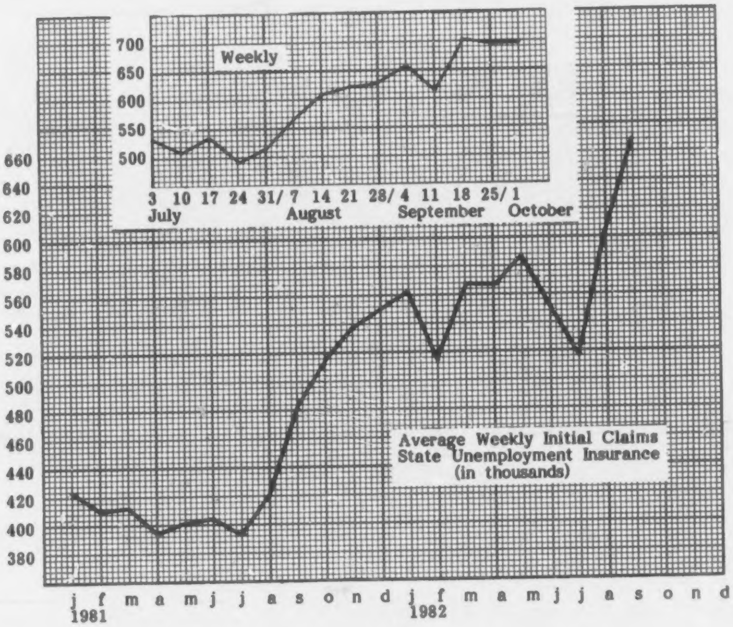


CHART 10 - INDEX OF LEADING ECONOMIC INDICATORS



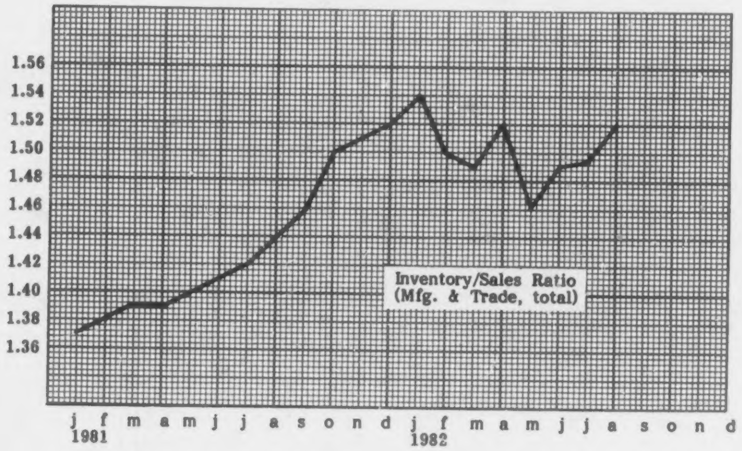
However, to the extent that one interprets the economy's sputtering as encouraging, early indications of September's activity must be comparably disheartening. Virtually all preliminary measures of economic activity (e.g. capacity utilization, industrial production, etc.) slipped in September. While in isolation this slip wouldn't hold much significance, it's particularly disconcerting that, after six months of stimulation, the economy still hasn't responded.

CHART 11 - INITIAL CLAIMS FOR UNEMPLOYMENT



Additionally disconcerting is the fact that the slowing rate of inventory liquidation (which helped to stabilize the economy) has pushed up the inventory sales ratio, thereby increasing the risks of another inventory liquidation based contraction.

CHART 12 - INVENTORY/SALES RATIO

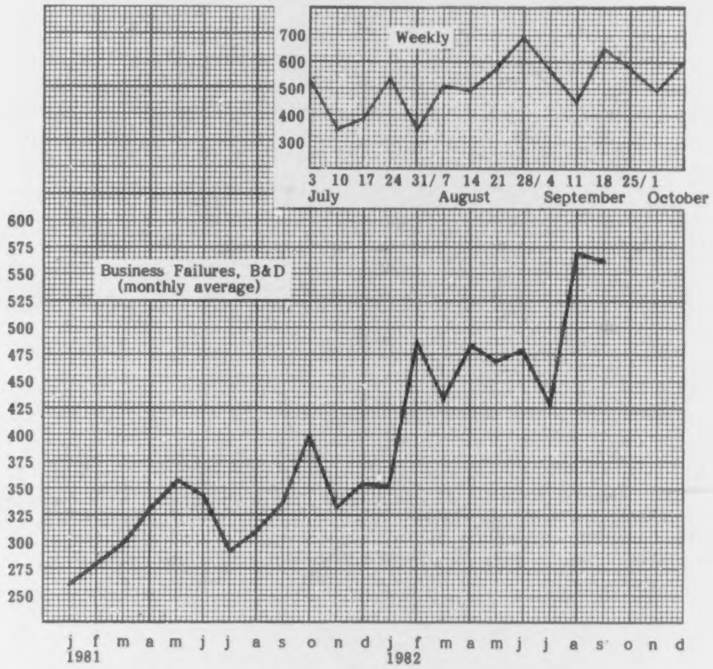


Since a contraction from these depressed levels is too frightening to contemplate, not nearly enough attention is given to it as a possibility and little is being done to insure it won't happen. It would certainly take the economy over the brink to failure (i.e. a lending crisis motivated contraction in which the economy is no longer responsive to monetary stimulation), if it is not over already.

FAILURE

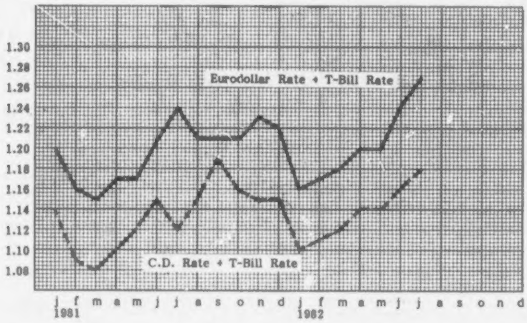
Unfortunately, at this level of activity, a stable economy is a deteriorating economy. While it's widely assumed that an economy which is expanding is getting stronger, changes in the economy's health are not primarily a function of changes in its direction but rather of the rate at which it's operating. For example, a falling economy operating at 85% of capacity will be strengthening while a rising economy operating at 70% of capacity will be deteriorating. While the economy is flat, businesses are failing at a rate which is higher than at any time since 1933 and is rising (see Chart 13), and countries are unable to service their debts in unprecedented numbers (in 1982 approximately thirty countries, roughly one in every five, will either seek "rescheduling" or simply refuse to pay).

CHART 13 - BUSINESS FAILURES



This risky environment has created a tiering effect in the credit markets (see Chart 14) - i.e. riskier borrowers are having a tougher time obtaining financing and having to pay premiums relative to secure borrowers. For example, Brazil, Mexico and Argentina are lucky to obtain financing at premiums (to the London Interbank rate) triple last year's levels (e.g. at 2 1/2%, 2% and 1 1/2% respectively). Changes in covered interest rates between countries also reflect the credit markets' increasing sensitivity to both economic and political risks. It is becoming more apparent to investors that, as countries slip more deeply into crisis, the battle intensifies between "those who have it" and "those who don't". The clearest barometer of these concerns is the movement of money. It used to be that prudent "world money" would stay out of the economically and politically more volatile "banana republics"[25] and move between the more secure industrialized countries, chasing the highest covered yields. However, as the industrialized countries became riskier[26], covered yields have become of secondary importance - the primary attraction to "world money" is now a stable and conservative economic and political environment[27] (i.e. an environment in which those with money are winning the battle to hold onto it).

CHART 14 - EURODOLLAR ÷ T-BILL RATE[28]



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[25] *Typically, commercial bankers (who invested the funds of small depositors unable to evaluate the risks) and development organizations (both public and private) invested in these countries. Quite ironically, the same foreign banks who were pouring money into these countries also handled the funds of locals who wanted to get their money out.*

[26] *Europe has recently been the largest source of "flight money" into the U.S. This influx is directly the result of increasing economic and political risks, particularly in France, Italy, Germany and the U.K. While heretofore reducing or eliminating taxes and getting the highest returns were the primary advantages of having one's money offshore, there is a growing sense among Europeans that having money onshore in a bad economic environment is like standing among a pack of starving wolves eating a steak.*

[27] *Similarly, one only has to reflect on the 1973-78 flight from the dollar to realize how quickly the money which has been pouring into the U.S. would leave if the environment ceased being economically and politically conservative.*

[28] *In response to Donald Regan's October 6th speech assuring bankers that the Treasury and Fed were prepared to stand behind the System and the October 7th shift in monetary policy, recently there has been narrowing in these spreads.*

This flight to quality is by no means just an international phenomena. As business failures increase and balance sheets deteriorate at home, domestic lending practices change[29]. The "tiering" which has been taking place in the credit markets is a natural and unavoidable consequence of growing dichotomies in the financial health of borrowers. It's increasingly deceptive to look at the economy "as a whole". Rather than thinking of the economy as being homogeneous, it would be more accurate to think of it as being two-tiered with interest rate sensitive sectors[30] on the brink of failure and non-interest rate sensitive sectors still strong. Since there is no way for the economy as a whole to remain immune to a bankruptcy crisis among the interest rate sensitive sectors, in order to assess the probability of failure it's the latter group which should be examined. While it's important to recognize that the economy as a whole is headed for failure operating at under 70% of capacity[31], it's even more essential to consider the implications of little or no improvement among the interest rate sensitive sectors such as autos, construction, airlines, lumber, steel, heavy equipment, etc., which are operating at less than 55% of capacity and mining companies and farmers who are selling substantially below their costs of production.

In aggregate, the financial health of this large, interest rate sensitive sector of the economy is deteriorating rapidly. Its health will continue to deteriorate and failures among this sector will continue to rise unless there is an enormous reliquification. We estimate that if the economy remains flat or improves only modestly, the rate of business failures will increase by over 50% in the next six months. Since the rate of business failures is already unsustainably high and, in order to avoid failure, would have to decline significantly, we continue to assess the odds in favor of failure.

CONCLUSION

If there was ever a time of greater uncertainty, we can't remember it. The economy is now flat, teetering on the brink of failure. The Fed, growing more concerned at the precarious position, has shifted its posture from pushing the economy toward the brink to simply watching it teeter - if it starts to go over, they'll attempt to save it and if it moves away, they'll push it right back.

Where this balancing act will lead will become more apparent over the next several weeks. Although we're confident that the alternatives are as diagramed on the front page, we're by no means certain which of these alternatives will come to pass. Certainly, we have our expectations (hence our assigned probabilities[32]) but as traders we learned long ago that it can be costly to let one's expectations cloud one's judgment - we're too interested in being right to be proud. Over the next several weeks the evidence will build and the odds will shift clearly in favor of one of these alternatives. Just as the late 1979 transition period preceded three years of liquidity crisis and the mid-1929 period preceded five years of failure, the economy is now about to enter an extended period of either failure or hyper-inflation. It's therefore a time to cautiously observe the interplay of the crosscurrents in order to determine the direction of the economy as it emerges from this transition period.

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[29] *This is reflected in the slow decline in the price rate relative to the declines in CD rates and the widening spreads (both discounts and premiums) relative to prime that bank borrowers are paying.*

[30] *By interest rate sensitive sectors we mean all those affected adversely directly or indirectly by high interest rates and tight money.*

[31] *We estimate that an immediate increase to over 78% of capacity is needed to bring the failure rate down.*

[32] *Given the Fed's shift in policy, we would now assess the odds of response as about even and the odds of fueling a monetary expansion if they have the opportunity also at about even, implying a 75% chance of failure and a 25% chance of hyper-inflation.*

APPENDIX - THE MARKETS

As the markets have a profound impact on the public psychology and vice versa, it would be foolish for any economist to ignore their behavior. While markets are by no means perfect in their ability to discount the future, they are an excellent reflection of the shifts in the betting.

STOCKS

Probably the greatest single source of relief to growing anxiety over economic conditions has been the last two months' sharp advance in stock prices. As it's widely recognized that stock market advances typically precede economic upturns, there is a growing faith that a recovery is around the corner based on the magnitude of this particular advance. The implied premise is that those who buy stocks have in the past been good at anticipating upturns in the economy.

However, as shown in our August report, stock prices rise in response to falling interest rates, not anticipated economic upturns. While falling interest rates (and the increased liquidity they reflect) normally stimulate the economy, there's no direct connection between rising stock prices and an expanding economy. In other words, rather than stock prices rising in anticipation of economic expansions they rise in response to lower interest rates which typically stimulate expansions. 1929 was a classic example of falling interest rates causing stock prices to rise but failing to stimulate an expansion. When interest rates began to fall in May 1929, stock prices rose. This price advance extended 15% in magnitude and lasted until October 1929.

Perhaps the simplest way to show the relationship between stock prices and interest rates is to look at their relative yields. For example, prior to the bull moves in the stock and bond markets, the earnings yield of the stock market was 13%, which was equal to the 13% then available in high grade bonds. From their lows, the stock and bond markets each rose about 25% and now both yield around 10%. Similarly, prior to the interest rate fall/stock market rally, the gap between the yield in 3-month treasury bills (10%) and the dividend yield of stocks (8%) was 2%, the same as it is today (with t-bill yields around 7 1/2% and the dividend yield at 5 1/2%). When returns for being liquid were high and illiquidity was squeezing corporate profitability, it paid to have a high percentage of one's portfolio in cash. However, with the returns from being in cash falling and prospects for reliquification improving, large money managers have been shifting to stocks. Since liquidity is the most important influence on the world economy, it's not surprising that all markets react violently in response to changing prospects for reliquification. Although to some it might seem odd that the stock market rallies on bad news (e.g. the Mexican crisis and Penn Square), since the surfacing of each new crisis prompts the Federal Reserve to inject another dose of liquidity into the system, these rallies aren't as foolish as they first appear. Observe how last week's surge in the stock market began in response to Treasury Secretary Regan telling bankers that they "face six months to a year of difficult problems but can depend on help from the government if debtor nations detault". This bullish reaction to bad news is the rule, not the exception. The sequence is well established: bad news gets the Fed to push interest rates down and lower interest rates cause the stock market to rally. Just as bad news is bullish for the stock market, good news is bearish. Observe how on any signs of economic strength (e.g. a jump in durable goods orders) interest rates rise (fearing the Fed will take this as a sign that the economy can withstand some more tightening) and the stock market falls. While this perverse reaction to the Fed's policies seems odd, it's none-the-less justified. Since the odds of an economic collapse are reduced and the odds of an inflationary expansion are enhanced by the Fed turning stimulative, it's bullish to have the Fed scared.

This has not been a stock market rally buoyed by optimism. Look at the groups that led the advance - blue chips (for security), mining and oil companies (as inflation hedges) and high dividend yielding companies (in response to lower interest rates)[33]. It's also interesting to observe how the U.S. stock market significantly outperformed all other stock markets throughout the bull move despite the dollar strengthening against all other currencies except the Canadian dollar (reflecting the flow of money from nervous foreign investors into the U.S.). The expression "buying panic" seems appropriate in that the move was supported by institutional investors who were scared to be left on the side lines, foreign investors who were afraid to keep their money elsewhere and shorts[34] who realized that sticking with such a position could prove lethal.

GOLD

If one assumes that the Fed can stimulate and will nurture a recovery, one would have to be bullish on gold. Regardless of how bad political and economic disruptions become, for gold to increase in value relative to any currency the value of that currency must decline relative to goods and services (i.e. inflation must increase). It's therefore important to understand that the recent dollar denominated strength in the gold price developed primarily in anticipation of increasing U.S. inflation[35].

Although some economists argue that reduced inflationary expectations and the low rate of capacity utilization will prevent an inflationary acceleration, there is no precedent in support of this conclusion. The entire decline in inflation is directly attributable to the Fed's extremely tight money policies. High real interest rates reduced inflation by causing rapid inventory liquidation, weakening final demand and a strengthening dollar (which reduced the cost of imports). Although the core inflation rate has remained comparatively steady, commodity deflation helped to reduce the average rate - i.e. averaging positive numbers with negative numbers creates lower positive numbers. As the rate of commodity

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33. *During the week ended October 7th, bank stocks did exceptionally well in response to hopes of reliquification and pledges of government support, gaining 15% on average.*
34. *The short interest in August, at the bottom, was an exceptionally large 96 million shares.*
35. *Declining interest rates are also bullish for gold because of the lower carrying costs.*

deflation slows[36], the overall rate of inflation will rise (unless there is a significant decline in the core inflation rate which would take an economic collapse). If the Fed's stimulation creates an economic response and real interest rates are held down, inventory rebuilding, increasing final demand and a weakening dollar would lead to an inflationary acceleration. While the inflation rate would at first (over the next six months) increase moderately, by II Q 83 it would approach double digit levels and by 1984 reach 15-18%.

As shown in our August report, major interest rate declines following periods of illiquidity triggered significant gold price rallies (i.e. 32% to 44%). From the lows, this rally extended over 65% before correcting (it's now up 42%). While a long stock position is one way of betting that 1) the Fed's stimulation will trigger an economic response and 2) the Fed will nurture the recovery by "leaning into the wind", buying gold is a far better way. 15-18% inflation and low real interest rates imply a gold price of around $800-900 by 1984.

BONDS

Although the sharp advance in the stock market attracted the most attention, the advance in the bond market was equally sharp and on a total return basis[37] bond holders significantly outperformed stock holders.

We continue to feel strongly that high grade long term bonds are the best place for one's money. As we've said so many times before, if you can't own bonds you can't own anything. Interest rates must come down either because the Fed reliquifies (forcing them down) or because they don't reliquify (and the economy collapses). Contrary to popular belief, near term bonds will go up in response to reliquification simply because real interest rates would decline by enough to cause nominal rates to fall despite increasing inflation. On the other hand, if reliquification of the economy does not occur, both falling real rates and a falling inflation rate would cause bond prices to explode. By contrast, having your money in the stock or gold markets is a bet that 1) the Fed's stimulation will cause a response and 2) that the Fed will "lean into the wind" (thereby preventing an interest rate increase) while the economy is expanding.

In our March report, we projected "By mid-year we will see the Federal Reserve move to increase member bank reserves while private loan demand will be falling. The result will be a sharp fall in interest rates which will take the prime rate to around 8% by mid-1983...The major long term peak in interest rates will be seen sometime between late spring and mid-summer. The profit opportunities which will result from the second half 1982 drop in interest rates will be enormous. For example, leveraged investors who are long treasury bill, CD and eurodollar futures will make upwards of fifteen times their money while investors who are long bonds will make around 60% during this time." Although this move is now well underway, don't let the fact that it's come this far so fast prevent you from getting on board if you haven't already. Bond yields are still, even after their tumble, higher than at any time prior to Paul Volcker's appointment. They have been reflecting the last three years' liquidity crisis which is definitely ending. While there will be corrections in this bull move, these should be taken as buying opportunities.

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36. Commodities in aggregate are now, in real dollars, lower than at any time during the Great Depression and lower relative to the cost of production and government support levels than ever before.

37. As contrasted from reliquification of the banking system which has already occurred.

CHART 15 - STEEL, CAPACITY UTILIZATION %

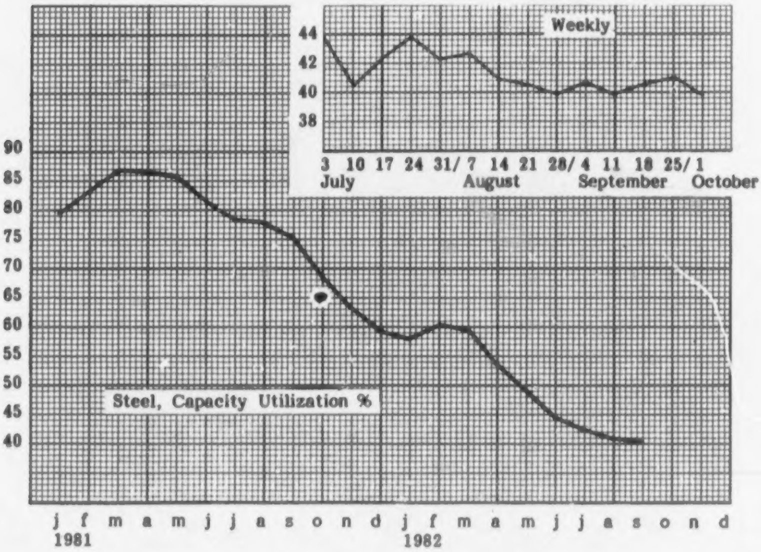


CHART 16 - STEEL, CAPACITY UTILIZATION, % CHANGE YEAR AGO

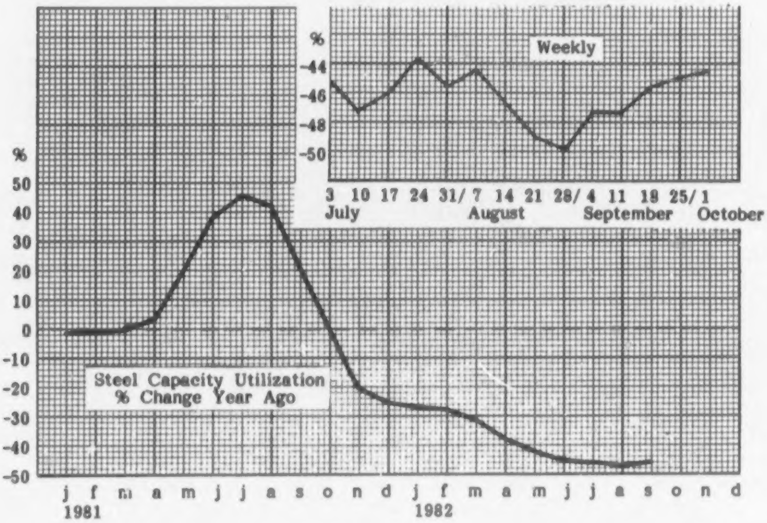


CHART 17 - AVERAGE INITIAL CLAIMS STATE UNEMPLOYMENT INSURANCE

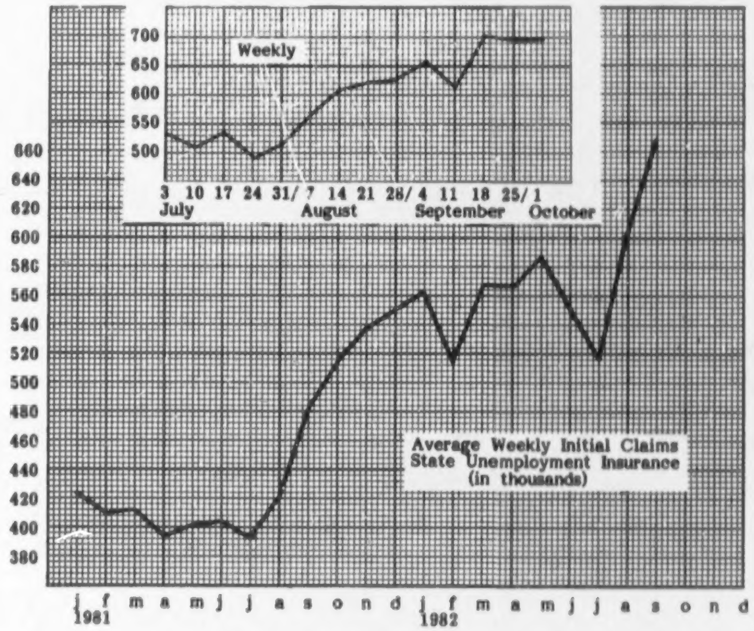


CHART 18 - INITIAL CLAIMS FOR UNEMPLOYMENT, % CHANGE YEAR AGO

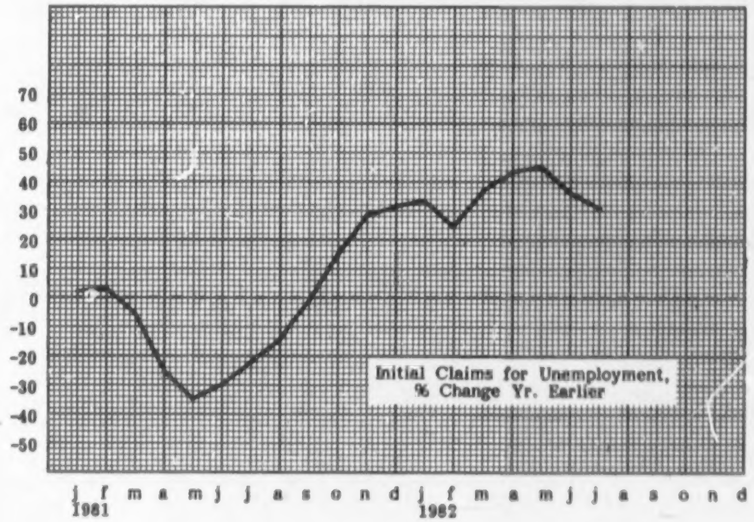


CHART 19 - ADVANCE PLANNING

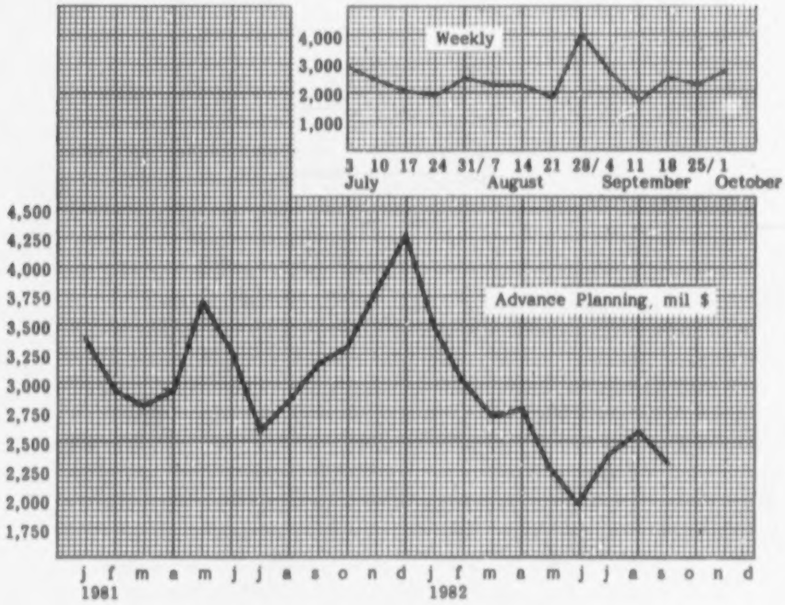


CHART 20 - ADVANCE PLANNING, % CHANGE YEAR AGO

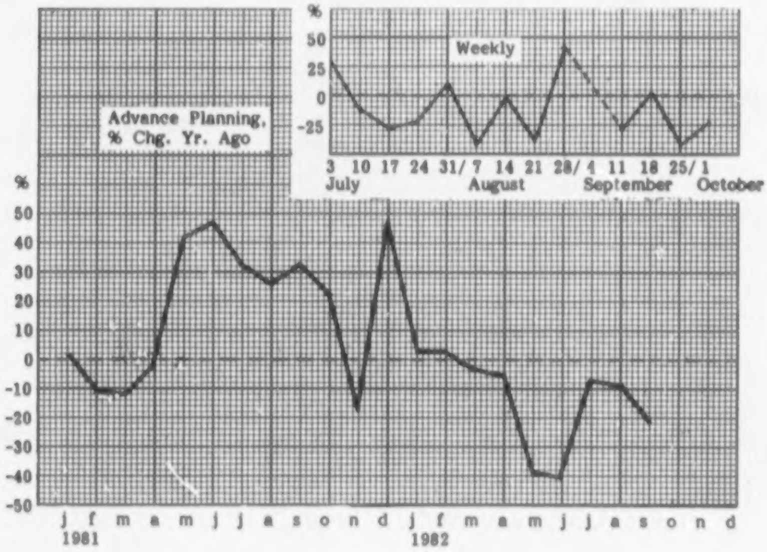


CHART 21 - U.S. AUTO OUTPUT, AVERAGE WEEKLY SALES

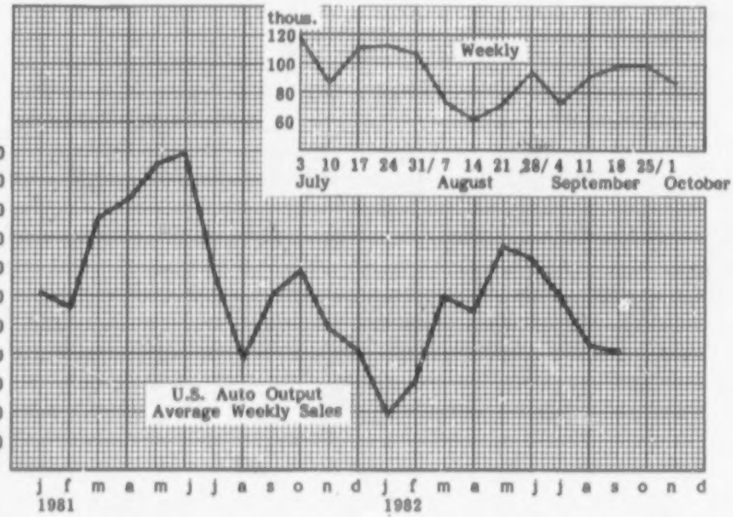


CHART 22 - U.S. AUTO OUTPUT, % CHANGE YEAR EARLIER

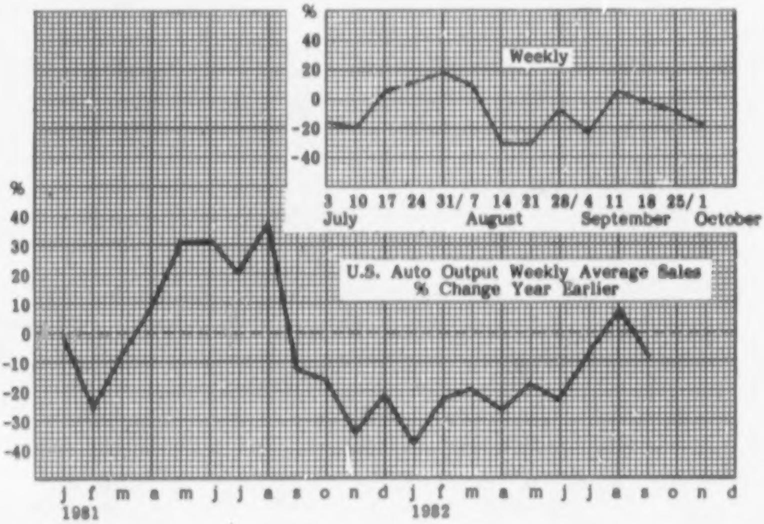


CHART 23 - PETROLEUM REFINERY % UTILIZATION

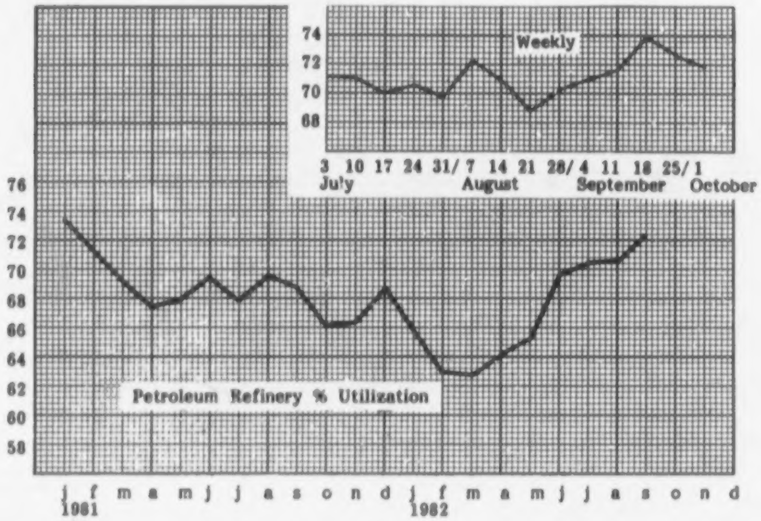


CHART 24 - PETROLEUM REFINERY % UTILIZATION, % CHANGE YEAR AGO

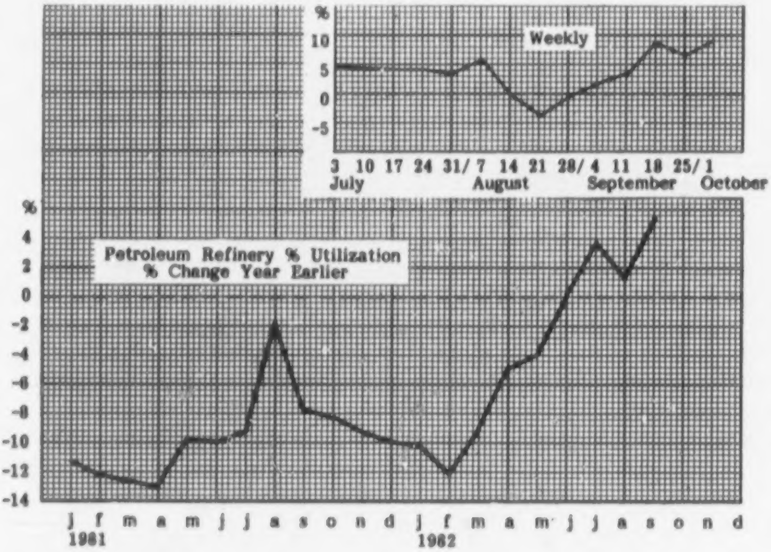


CHART 25 - ELECTRIC POWER PRODUCTION

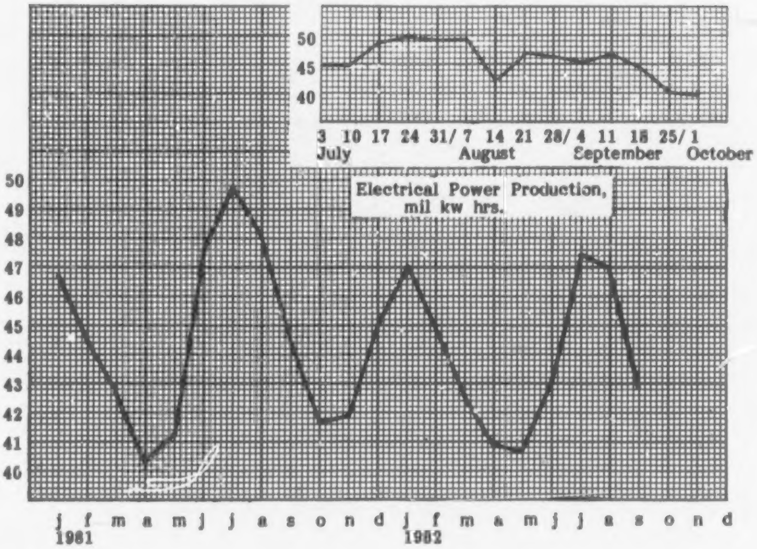


CHART 26 - ELECTRIC POWER PRODUCTION, % CHANGE YEAR EARLIER

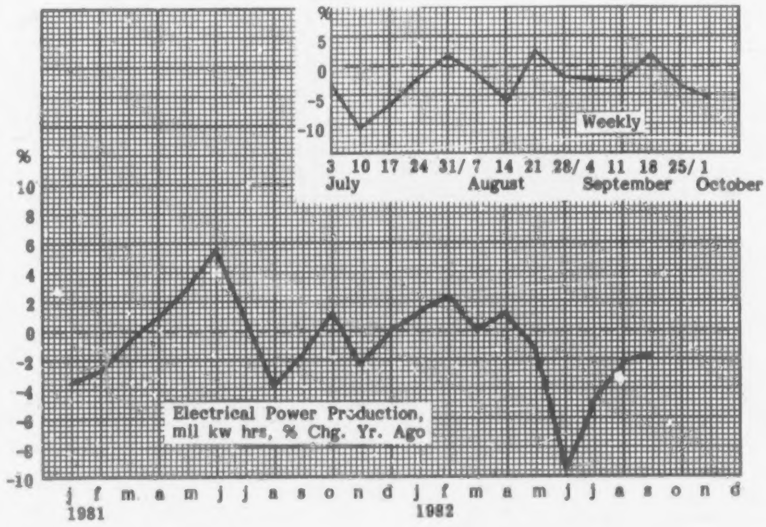


CHART 27 - PAPER PRODUCTION

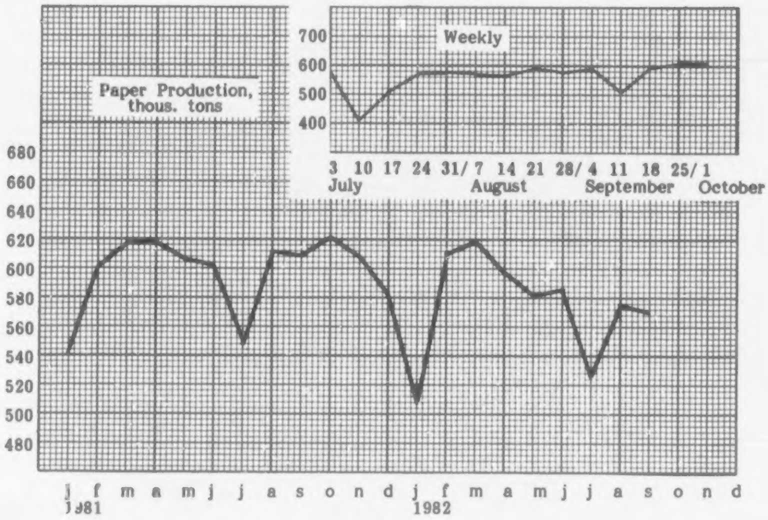
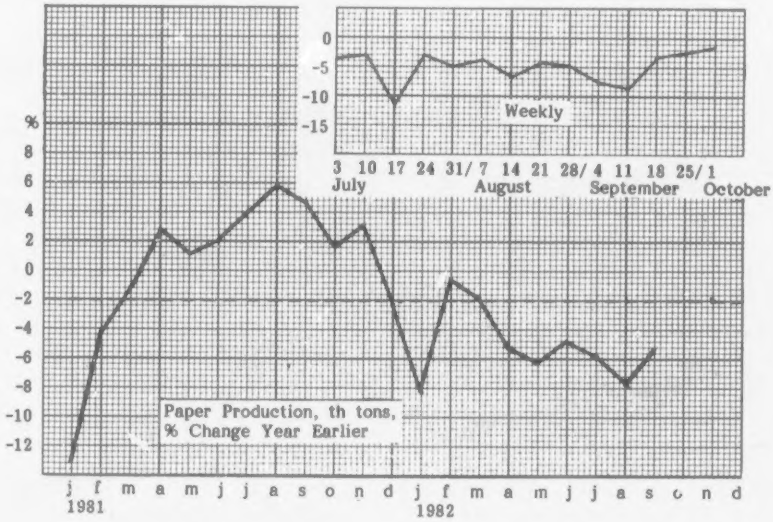


CHART 28 - PAPER PRODUCTION, % CHANGE YEAR EARLIER



	Wks. Ended															
	Jly 3	Jly 10	Jly 17	Jly 24	Jly 31	Aug 7	Aug 14	Aug 21	Aug 28	Sept 4	Sept 11	Sept 18	Sept 25	Oct 2	Oct 9	Oct 16
BANKING STATISTICS																
a) Commercial & Industrial Loans at Banks (mil. $)	207.985	208.384	207.769	206.508	206.285	206.831	206.862	207.120	206.069	207.618	208.334	211.086	212.231	212.603	214.922	
b) Commercial Paper, Non-Financial (mil. $)	58.932	60.003	61.047	60.576	59.024	59.355	59.268	58.420	57.802	57.864	57.280	58.325	58.303	57.023	58.333	
c) Commercial Paper, Financial (mil. $)	120.913	121.594	120.238	122.301	122.802	120.903	120.219	119.898	118.844	116.054	113.914	114.123	115.818	115.426	115.297	
d) A + B	266.917	268.387	268.816	267.084	265.309	266.186	266.130	265.540	263.871	265.482	265.614	269.411	270.534	269.626	273.255	
e) A + B + C	387.530	389.981	389.054	389.385	388.111	387.089	386.349	385.438	382.715	381.536	379.528	383.534	386.352	385.052	388.552	
f) Total Reserves (bil $)	41.785	41.672	40.770	41.710	41.688	41.676	41.665	42.073	41.771	41.999	39.554	39.562	39.767	39.642	39.936	39.243
g) Excess Reserves (mil.	597.0	694.0	165.0	0.350	0.271	0.333	0.358	0.281	0.239	0.387	0.719	0.422	0.204	0.291	0.607	0.515
h) Net Free Reserves (mil. $)	-548.0	+ 40.0	- 92.0	- 17.0	- 65.0	-161.0	+186.0	+ 52.0	-158.0	+ 91.0	+ 82.0	-702.0	-387.0	-222.0	+230.0	+342.0
i) Monetary Base (bil. $)	172.600	172.430	171.607	172.640	172.819	173.376	173.247	174.019	173.775	174.603	171.340	171.790	172.001	172.164	172.408	172.331
j) M1 Multiplier	2.605	2.583	2.633	2.616	2.607	2.616	2.618	2.614	2.626	2.618	2.696	2.681	2.680	2.677	2.659	2.698
k) M1 (bil. $)	449.6	445.4	451.8	451.6	450.5	453.5	453.5	454.9	456.3	456.9	461.9	460.6	461.0	460.9	458.0	464.9
l) M2 (bil. $)	n/a	n/a	n/a	n/a	1,923.3	—	—	—	1,946.2	—	—	—				
m) Consumer Price Index	—	—	—	—	291.4	—	—	—	292.4	—	—	—				
n) M1 ÷ CPI	153.9	152.4	154.6	154.6	154.6	155.1	155.1	155.1	156.1							
o) M2 ÷ CPI	—	—	—	—	660.0	—	—	—		—	—	—				
p) T-Bill Rate	13.01	12.59	11.88	11.06	10.51	9.92	9.99	8.68	7.43	8.00	8.31	8.16	7.75	7.50	7.82	7.58
q) Fed Funds Rate	14.81	14.47	13.18	12.14	11.02	11.15	10.90	10.11	9.04	10.15	10.14	10.27	10.31	10.12	10.77	9.60
r) CD Rate	15.25	15.13	14.13	13.34	12.08	11.63	11.65	10.51	9.59	10.11	10.53	10.81	10.84	10.53	10.58	9.59
s) Prime Rate	16.50	16.50	16.50	16.00	15.50	15.00	14.00	13.50	13.50	13.50	13.50	13.50	13.50	13.25	13.00	12.25
t) Long Term T-Bond Rate	—	—	—	—	12.97	—	—	—	12.15	—	—	—	11.58	—	—	—
u) CD - T-Bill Rate	2.24	2.54	2.25	2.28	1.57	1.71	1.66	1.83	2.16	2.11	2.22	2.65	3.09	3.03	2.76	2.01
v) Prime Rate - CD	1.25	1.37	2.37	2.66	3.42	3.37	2.35	2.99	3.91	3.39	2.97	2.69	2.66	2.72	2.42	2.66
w) T-Bill Rate ÷ T-Bond Rate	—	—	—	—	.81	—	—	—	0.61	—	—	—	0.72	—	—	—
ECONOMIC ACTIVITY (monthly)																
a) Capacity Utilization	—	—	—	—	69.9	—	—	—	69.4							
b) Durable Goods Orders (bil. $)	—	—	—	—	33.02	—	—	—	31.68							
c) Housing Starts (thous. annual)	—	—	—	—	1,195.0	—	—	—	1,002.0							
d) Domestic Auto Sales	—	—	—	—	5.1	—	—	—	5.4							
e) Index of Leading Indicators	—	—	—	—	129.8	—	—	—	128.6							
f) Industrial Production	—	—	—	—	138.7	—	—	—	138.4							
g) Retail Sales, 1972 dollars (mil. $)	—	—	—	—	44,301.0	—	—	—	43,817.0							
ECONOMIC ACTIVITY (weekly)																
h) Initial Claims for Unemployment (thous.)	532.0	510.0	536.0	494.0	517.0	568.0	608.0	621.0	629.0	658.0	613.0	703.0	697.0	695.0		
i) Business Failures	522.0	341.0	383.0	540.0	343.0	512.0	494.0	572.0	696.0	563.0	453.0	657.0	579.0	491.0	598.0	
j) (% Change from Year Earlier)	+207.1	+ 52.2	+ 22.4	+ 60.7	- 0.9	+ 44.6	+ 41.6	+ 70.8	+148.57	+ 85.2	+ 46.6	+ 68.0	+ 68.8	- 2.1	+ 27.78	
k) Auto Output	119,852.0	87,752.0	114,614.0	116,648.0	106,354.0	73,302.0	62,273.0	72,751.0	93,320.0	76,941.0	90,537.0	98,336.0	99,028.0	87,089	79,938.0	94,543.0
l) (% Change from Year Earlier)	- 15.7	- 19.7	+ 4.9	n/a	+ 17.0	+ 10.4	- 30.4	- 30.1	- 7.64	- 24.3	+ 5.1	- 3.8	- 10.46	- 19.0	- 29.29	- 23.01
m) Electrical Power Production	44,657.0	44,971.0	48,644.0	49,824.0	49,073.0	49,136.0	42,285.0	46,786.0	46,032.0	45,180.0	41,699.0	44,427.0	40,274.0	39,797.0	41,266.0	
n) (% Change from Year Earlier)	- 3.0	- 10.8	+ 6.7	- 2.1	+ 1.5	- 1.5	- 6.0	+ 2.2	- 2.0	- 2.5	- 2.98	+ 1.9	- 3.26	- 5.70	- .57	
o) Paper Production	573.0	414.0	505.0	569.0	576.0	570.0	565.0	588.0	579.0	587.0	505.0	593.0	602.0	606.0	589.0	
p) (% Change from Year Earlier)	- 3.9	- 3.0	- 11.3	- 3.1	- 5.0	- 3.7	- 6.8	- 4.1	- 4.9	- 7.6	- 8.8	- 3.3	- 2.59	- 1.94	- 6.06	
q) Petroleum Refinery % Utilization	71.2	71.1	70.0	70.5	69.8	72.3	70.9	68.8	70.2	71.0	71.6	73.9	72.7	71.8	71.3	
r) (% Change from Year Earlier)	+ 4.9	+ 4.4	+ 4.2	+ 4.1	+ 3.3	+ 5.6	0.0	- 3.8	- 0.6	+ 1.9	+ 3.3	+ 8.7	+ 6.9	+ 9.12	+ 9.02	
s) Steel, % Capacity Utilization	43.9	40.5	42.3	43.8	42.3	42.6	40.9	40.5	39.9	40.6	39.8	40.5	41.0	39.9	41.0	
t) (% Change from Year Earlier)	- 45.4	- 47.4	- 46.1	- 43.7	- 45.6	- 44.5	- 46.8	- 48.9	- 49.8	- 47.3	- 47.4	- 45.7	- 45.0	- 44.6	- 43.50	
u) Advance Planning (mil. $)	2,925.1	2,446.4	2,063.4	1,994.7	2,535.0	2,271.2	2,280.4	1,829.1	4,004.8	2,699.4	1,760.9	2,510.4	2,237.2	2,727.7	3,715.9	3,086.2
v) (% Change from Year Earlier)	+ 27.5	- 11.6	- 28.9	- 23.0	+ 8.1	- 41.3	- 1.5	- 36.6	+ 42.00	—	- 29.8	+ 2.0	- 42.5	- 21.7	+ 28.36	- 9.34

Representative REUSS. Thank you, Mr. Dalio.
Mr. Evans.

STATEMENT OF MICHAEL K. EVANS, PRESIDENT, EVANS ECONOMICS, WASHINGTON, D.C.

Mr. EVANS. Thank you very much, Mr. Chairman. It's always a pleasure to appear before this committee, although this is the first time I ever heard anybody more pessimistic than I am. It's a new experience for me.

I will briefly discuss where I think the economy is going and then answer some of your specific questions about fiscal-monetary policy. I will, of course, abstract from my prepared statement.

I think the U.S. economy is at least 1 year and possibly 2 years away from a sustained recovery.

In my 20 years as a professional forecaster I have seen many recoveries emerge and mature and I have never seen one start like the position that we are currently in: New orders for capital goods, down 22 percent the past year; the Federal budget deficit threatens to engulf the entire supply of new saving; long-term real interest rates are 6 percent instead of their normal 2 to 3 percent; the number of initial unemployment claims has risen 35 percent in the past 2 months; the Commerce Department's own index of leading economic indicators, down 0.9 percent in most recent months.

This is only a short list, Mr. Chairman. Your list in the introduction was longer but conveys the same impression.

I think the surge in the stock market stems from weakness rather than strength and it has occurred entirely because interest rates have fallen. In the past 3 months stock prices are up 20 percent but interest rates are down 24 percent, indicating that the other factor which moves stock market prices; namely, expected future profitability, has actually deteriorated in the past 3 months, and I think this will continue.

Representative MITCHELL. Mr. Evans, excuse me. Will you run through that again for me, please, on the performance of the stock market?

Mr. EVANS. Oh, sure. As I said, over the past 3 months the stock market is up about 20 percent but interest rates are down 24 percent. So the other component of stock market performance, which is expected future profitability, has actually deteriorated over the past 3 months, and I expect it will continue to do so.

As far as the GNP figures go few will take joy from the 0.8 percent increase that occurred. In my own forecast I have predicted a slight decrease. Just comparing my numbers with the ones that were released, I see that my numbers agreed exactly with the decline in final sales of $2 billion.

I had not estimated the degree to which inventories had increased. But this is clearly bad new rather than good news, because with these new figures we have approximately $20 billion worth of inventories that have to be worked off over the next few quarters and this will result in a decline in GNP in the fourth quarter, very little growth in the first quarter, and a continued rise in the unemployment rate. My figure of 11 percent unemployment is not reached until later in 1983 than yours, Congressman Mitchell, but I share the same opinions that the unemployment rate will continue to increase.

Furthermore, I believe that the Fed will once again reverse signals. We have heard Mr. Volcker speak on many occasions, and I would just like to read something that Mr. Volcker told a national audience on Issues and Answers on October 29, 1979. I quote directly from his remarks on that date. He said:

> As inflation comes down, which is the whole object of our policy, that is the only fundamental way to get interest rates down. * * * I have no hesitation in saying that the kind of policies that we are following will bring interest rates down quicker and lower than if we took any other approach.

Now that's October 29, 1979. The rate of inflation was 13 percent; it has indeed declined to the 5 to 6 percent level. The triple A corporate bond rate was 10.5 percent then; now it is 12.1 percent. The mortgage rate was 11.3 percent then; it is now, according to the latest Federal Reserve figures, 14.6 percent.

So I submit that Mr. Volcker's method of bringing down interest rates quicker and lower than any other approach has not worked. As we know, monetary policy has focused very closely on the monetary aggregates.

I believe that the switch away from the monetary aggregates is only temporary, and that after election time, as money supply, M_1, grows at double digit rates between July and the end of the year that Federal Reserve policy will tighten again and that we will have an increase in interest rates in the first quarter of 1983, with the prime rate rising to perhaps 15.5 percent in March or April or next year. This will be sufficient to choke off any recovery which might have otherwise occurred and will result in real GNP for 1983 growing at a rate of approximately only 1 percent, with the other details given in my tables in the appendix to my prepared statement.

I don't want to spend a lot of time going over all of the various reasons the GNP is low. I will touch on them very briefly, summarizing my comments here.

Consumer spending will not lead the way out of the recession. Consumers are (a) scared, and (b) broke. They are scared for good reason. The unemployment rate, 10.1 percent, is, of course, the highest since 1940, but continues to move up, it will be higher in coming months as indicated by the rise in initial unemployment claims. Consumers are broke in the sense that real per capita wage and salary income has declined steadily now for almost 3 years. The personal income numbers show an increase, but most of that increase occurs in interest payments which are additions to savings accounts, money market funds, and so forth. The average rank and file worker doesn't have very much invested. It's his income or her income which is going down.

Because of this I think that the tax cut will have only a moderate effect on consumer spending. The tax cut, we should all be reminded, amounted to approximately $4 a week for the average American worker on July 1, 1982, and while I have some kind things to say about tax cuts in general, it would be fatuous in my opinion to expect that a $4-a-week increase would have all by itself served as a miracle drug to turn the economy around. The negative psychological implications of the continuing recession and the double digit unemployment rate have far outweighed this modest increase in income, as we have seen in the past few months.

As far as the inventory situation goes, I've already referred to the fact, based on the recent figures, that we have a $20 billion decline in inventory investment to occur in the next few months.

Fixed business investment is in very bad shape. The Commerce Department surveys show a 4.4 percent decline in real terms this year. When the new investment surveys which come in November are released next month, they will in my opinion show a decline of at least 5 percent in capital spending in real terms next year. It is rumored that some surveys even show as much as a 10 percent decline.

Finally, we have heard some good news about the housing industry because housing starts were up 14 percent yesterday. I would submit that the housing market is still far away from equilibrium. For many, many years, through the 1950's and the 1960's, the average ratio of the average monthly payment to household disposable income remained constant at about 20 percent. This ratio has now risen to approximately 32 percent. Even if you adjust for creative financing, it's about 30 percent. Four out of five average American families still cannot afford the monthly payment on a new mortgage even though interest rates have declined. In my opinion we will have no complete recovery in the housing industry until those mortgage rates and housing prices have declined to put the ratio of monthly payments to income back to their old levels. And I do not expect this to happen until 1985.

Thus with consumer spending weak, with housing weak, with capital spending weak, and not so incidentally, with our net export balance deteriorating sharply because of the strength of the dollar, with our offsetting cost reductions or productivity improvements, no sector is going to lead us out of this recession.

The only thing that has increased in the past quarter is inventory investment. Everybody knows you don't start a recovery by stockpiling excess, unwanted inventories. This has never happened before. The reason it happened at all was that, although I find this hard to believe, many businessmen believed the consensus forecast back in April and they started stockpiling inventories in advance of this great boom which was going to come from this $4-a-week tax cut. But when it didn't happen they found themselves with excess inventories. We have to go through yet another leg of the recession which will take us well into 1983.

Economists are supposed to have solutions to what ails us. This is not as easy a part of the talk to give as it used to be. But I would like to suggest that we need a radical restructuring of our fiscal policy.

Some of the economists on this panel and elsewhere have indicated that budget deficits don't really matter. I would like to say that under the present circumstances, under the present set of laws for fiscal policy which currently exist, not only will we have a $175 billion budget deficit next year, but the budget deficit as a proportion of GNP will continue to increase even after the economy recovers, if in fact it does. We have built-in increases in spending: we have tax laws which are structured so that the increase in tax receipts will be lower than the increase in GNP.

I have long been associated with the general thrust of supply-side economics, and I'm not going to back off and say I don't believe in that, although admittedly I'm one of the few people that even mentions the term anymore. But I do believe that the high marginal tax rates which we have had in the past have impeded the advancement in saving and investment and productivity and have to a certain extent hindered work effort and individual incentive. What I would like to propose is an increase in average tax rates coupled with a decrease in marginal tax rates. This would occur through a modified flat rate income tax.

I have worked out a number of figures, which are shown in these tables. If those who are following my statement would turn to table 2, I have calculated a flat rate income tax, modified as follows: A $2,500 personal exemption, retention of deductions for charitable contributions, catastrophic medical expenses, home mortgage interest, and State and local taxes paid, but closing of all other tax preferences, deductions, loopholes, whatever you call them. Such a flat rate tax would bring the same amount of revenue as our current tax laws will in 1984 at a rate of 16 percent.

That assumes that there would be no advantages to the flat rate tax. However, we are now under a system where approximate $550 billion worth of personal income has no taxes paid on it. About $350 billion of this represents unreported income or overstated deductions. These are not my figures; these are from testimony offered by Commissioner Roscoe Egger of the IRS last March. In addition to this $350 billion in unreported income, we have an additional $200 billion in tax shelters, loopholes, tax-free municipal bonds and all the other areas with which we are familiar. I believe that the introduction of a flat rate tax would in fact close the gap and that two-thirds of the unreported income would indeed be reported at a 16-percent marginal tax rate.

In table 4 I have indicated the effect of a flat rate tax on Federal tax receipts. Table 4 shows that the total tax receipts which would be collected in 1984 under current law are $311 billion; the amount of tax receipts that would be collected under a 16 percent flat rate tax, according to my estimates, would be $430 billion—an increase of $119 billion, even if we ignore supply-side effects. If we then bring in supply effects, which might add an extra $30 billion, we would come very close to balancing the budget through a flat rate tax.

So I submit that one way out of our dilemma would be to change our tax structure, to implement a flat rate tax, to close off our tax loopholes, but to lower high marginal tax rates. I believe this would reduce our budget deficit without impeding on the flows of savings and investment. I believe that this would then provide the strength for a balanced recovery, a sustained growth with no deterioration in the inflation rate, and it would also lead to a balanced budget in perhaps 3 or 4 years.

Without a radical change in fiscal policy, however, I believe that the economy is likely to endure several more years of stagnation, because I believe the budget deficit is so large, and with the reluctance to cut spending either for social welfare or defense programs, I believe that we will continue to have increasing deficits as a proportion of GNP.

Now, as long as the economy is in recession, as long as there is no increase in private sector borrowing, then the Government can borrow as much as it wants without raising interest rates. However, as soon as the economy starts to improve, as soon as we have an increase in consumer borrowing and corporate borrowing, this borrowing will reach a collision course with the Government borrowing and send interest rates up once again.

I expect that this pattern will be repeated in early 1983 and perhaps again in early 1984, leading to a period of sustained stagnation without fiscal reform. Thank you.

[The prepared statement of Mr. Evans follows:]

PREPARED STATEMENT OF MICHAEL K. EVANS

The U.S. economy is at least one year, and possibly two years, away from a sustained recovery.

In my 20 years as a professional forecaster, I have seen many recoveries emerge and mature. But I have never seen one start in a situation when new orders for capital goods have declined 22% during the past year, when the Federal budget deficit threatens to engulf the entire supply of new saving in the following year, when long-term real rates of interest are still 6% instead of their normal 2% to 3%, when the number of initial unemployment claims has risen 35% in the past two months, and when the Commerce Department's own index of leading economic indicators has just fallen 0.9% in the most recent month.

The surge in the stock market stems from weakness, not from strength. It reflects the fact that interest rates have fallen because of lack of demand in consumer purchases, in housing, and in capital spending. In fact, during the past three months, stock prices have risen less than bond prices -- indicating that the other component of stock market behavior, namely expected future profitability, has actually deteriorated.

To be sure, the economic signals are never unequivocal, and some have managed to take heart from the recent increases in stock prices, the decline in interest rates, and the apparent further reduction in inflation. And of course the "prosperity is just around the corner" folks, who are never absent even in the worst economic times, are cheerfully reminding us that things must soon get better because the economy is currently so far down.

In fact, the economy probably will show a modicum of strength in the next few months. Lower interest rates will probably result in an increase of 2% to 3% in real consumption, and the current phase of inventory liquidation should come to an end shortly after the first of the year. When this happens, it is likely that real GNP could increase as much as 4% for a few months. But it is our position that this increase is not sustainable. For the rise in consumer spending and borrowing will bring about renewed congestion in financial markets. Interest rates will rise anew and any chance of sustained recovery will be aborted.

Ordinarily the net national saving rate -- personal saving, net corporate saving, and government saving -- averages about 6% of net national product. Next year, however, the Federal budget deficit will reach approximately $175 billion, which will account for 6% of GNP all by itself. All other savings flows in the economy will be about 3%. As a result, the total net national saving rate will be 3% instead of 6%. We are facing a shortfall of approximately $100 billion in saving.

As long as the economy is weakening and private sector loan demand is stagnant or declining, the Federal government can borrow virtually all it wants without pushing up interest rates further. However, once the private sector begins to recover, a collision course is all but inevitable. With inadequate supplies of savings, interest rates are forced back up, and the economy enters yet another leg of this already over extended recession.

In addition to the likelihood of higher interest rates snuffing out any chance of recovery in consumer spending, the portents remain dim for other components of GNP. The housing industry cannot recover until the ratio of the average monthly payment to household disposable income returns to approximately 20%; currently it is about 32%. Capital spending will decline almost 5% in real terms this year, according to the latest Commerce Department survey results, and is poised to fall at least another 5% next year. Our net export position continues to deteriorate as a strong dollar is not matched by cost savings in our basic industries here at home; indeed, union demands continue to escalate even as capacity utilization rates fall to 45-year lows. State and local governments continue to reduce their expenditures in real terms as Federal grants and state and local revenue bases diminish.

Based on this grim outlook it is all but certain that the unemployment rate will continue to rise throughout 1983 and probably into 1984 as well. If real GNP increases only 1% next year, then with labor force growing at about a 2% rate, it is a matter of simple arithmetic that unemployment will increase another 1% in 1983. This would put the rate near 11% by the end of 1983. Even if the economy does perform somewhat better in 1984, the unemployment would still remain above 10% two years from now. We would not see a decline to the 7.4% rate of January 1981 until mid-decade at earliest, with the possibility that this might not occur until almost 1990. Even the highly successful Kennedy-Johnson program, during which real GNP grew at an annual average increase of 5.4% from 1962 through 1966, only reduced the unemployment rate by 2.9% over this period. Thus even an all-out boom would not bring the unemployment rate much below 7%, and we are far from having programs in place which would insure such a boom.

The next section of these remarks covers the sector-by-sector outlook for the U.S. economy for the next year. In the concluding section we then turn to a possible way out of the current morass.

The Consumer Sits On The Sidelines

It should now be apparent to all that the initial effect of tax cuts is to raise saving and lower interest rates, not to raise consumption. Furthermore, we think that anemic consumer growth will continue throughout 1983 as well because of the following factors:

1. Virtually no growth in real per capita wages and salaries;
2. Lower growth in transfer payments due to lower inflation;
3. Negative psychological implications of double-digit unemployment rates; and
4. The long-term effect of a higher real rate of return on saving.

The first item may appear to be somewhat at variance with the 2.3% increase in real disposable income for 1983 contained in our forecast. However, that figure must be modified in several ways. First, the tax cuts will be saved rather than spent. Second, most of the increase in real personal income stems from higher interest income, which is income in an NIPA sense but not in a spending sense. In other words, most of that income is accrued to savings deposits of one form or another and is not even considered to be part of the short-term spending stream by its recipients. Third, with no increase in productivity, both wages and prices will rise about the same amount, and with gains in employment being matched by growth in the labor force, per capita income will not increase.

The second point is somewhat more complicated in the sense that lower inflation is usually considered to be a boon for consumption. After all, the major reasons for this extended recession is to lower inflation, is it not? For only with lower inflation can we have higher saving and investment, greater productivity, and an increase in the real standard of living.

All true enough when lower inflation is caused by an increase in productivity; then real wages rise and everyone is better off. Yet now that the initial excess demand has been squeezed out of the system, any further reduction in inflation will be accompanied by lower gains in wages and no improvement in productivity. As a result, living standards for labor will not rise at all.

In addition, transfer payments which are linked to the cost of living will also rise less rapidly next year. As a first approximation, one might argue that this too is a wash, since the lower benefits received are offset by smaller price increases of the goods and services which are purchased. However, for those whose sole or even primary support is social security benefits, the CPI is a very poor indicator of what things cost. For the most part, the elderly do not buy new houses, particularly with mortgages. They do not have to bear the cost of medical care services. They are presumably finished paying for their children's college education. They do not partake of business-inflated travel, lodging, and food and entertainment expenses. Hence the true cost of living for the retiree rises much less than the CPI during periods of rapid inflation. In comparison, when inflation moderates and the benefits are correspondingly less generous in nominal terms, aggregate purchasing power suffers.

It used to be generally accepted that high unemployment rates caused reduced spending, as consumers saved more for the rainy day when they too might be laid off or fired. During the 1970's this effect appeared to be muted, as the long-term secular increase in unemployment appeared to have little effect on consumption. However, the recent sharp increase in unemployment -- 2.5% in the past 12 months -- has once again raised the spectre of depression, and has convinced an increasing number of consumers to be much more cautious and thrifty than they have been over the past two years. We do not see this cloud of pessimism lifting as long as the unemployment rate remains above 10%, which is to say at least through next year.

The fourth factor represents the effect of the aftertax real rate of return on personal saving. The original estimates in our supply-side model showed that a 1% change in the rate of return would change the personal saving rate by about 1%, a result still incorporated in the present version. However, the real rate of return is calculated as the Aaa bond yield on an aftertax basis minus the inflation rate over the past four years. Hence the increase in the real rate of interest which started in 1980 will just begin to have its full effect on the saving rate in 1983 and later years; a listing of these variables is given in Table I.

To be sure, most economists do not accept this argument; the supply-siders are generally on the defensive, and everyone else dismisses it as so much hogwash. However, an alternative sociological theory has grown up in its place to explain the obvious economic facts which few wish to acknowledge. We now hear that it is not smart, not "chic" to spend so much money on spacious real estate, ostentatious jewelry, overpriced motor cars, lavish parties, and so forth. With the economy in such bad shape, it is claimed, even the rich are withdrawing their horns somewhat in order to blend in better with the generally lower living standards of the middle class and the poor.

Perhaps. But a more forceful, direct reason is simply that when the real rate of interest moves from -5% to +5%, the extra $100,000 spent per year on durables no longer can be justified even as a quasi-investment. During the 1970's, money spent on fixed-supply assets was an excellent hedge against inflation; even Mercedes Benz and Rolls Royces cars generally appreciated in nominal terms. Today they are a terrible investment, and the best thing one can do with his money is to put it into liquid assets. While the rich themselves may prefer a sociological explanation to an erudite discussion about aftertax real rates of return, the underlying economic factors are, we believe, the primary ones.

Our forecasts show only a moderate increase in the saving rate, from 6.7% in 1982 to 7.9% and 8.0% in 1983 and 1984, particularly in view of the third stage of the tax cut. However, this is in line with the slow increase in our definition of the real rate of return. In addition, it represents the fact that people are in general getting poorer, so they have less to save -- just as in the Great Depression the personal saving rate was actually negative even though the real rate of return was high. In any case the picture is not very alluring, with real consumption rising only 1.0% in 1983.

TABLE I

PERSONAL SAVING RATE AND REAL RATE OF RETURN

Year	Personal Saving Rate, Annual	RR	Year	Personal Saving Rate, Annual	RR
1955	5.9	0.1	1969	6.3	0.7
1956	7.3	0.4	1970	8.0	1.1
1957	7.3	0.3	1971	8.1	0.2
1958	7.4	-0.1	1972	6.5	0.1
1959	6.2	0.1	1973	8.6	-0.1
1960	5.6	0.1	1974	8.5	-0.8
1961	6.3	0.6	1975	8.6	-1.7
1962	6.0	0.8	1976	6.9	-2.2
1963	5.4	0.9	1977	5.9	-2.8
1964	6.7	1.2	1978	6.1	-1.7
1965	7.1	1.2	1979	5.9	-1.9
1966	6.9	1.3	1980	5.8	-2.1
1967	8.1	1.3	1981	6.4	-1.9
1968	7.1	0.9	1982P	6.9	-0.8
			1983E	7.8	+0.3

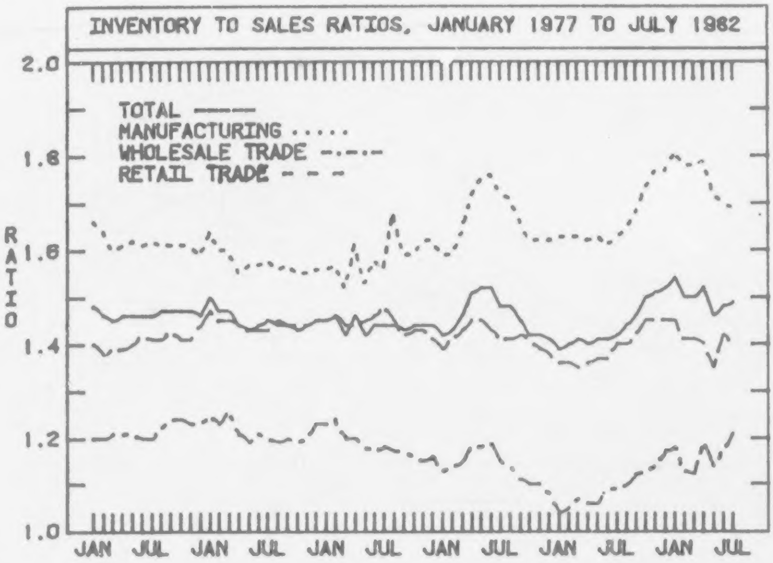
We do expect some improvement in consumption during the fourth quarter, the cause being the usual 4- to 5-month lag following the reduction in interest rates in July. Yet the odds are against a sustained improvement in consumer spending, both for the reasons given just above and because any strength in the economy will result in higher interest rates shortly thereafter.

Another Leg Down For Inventories

Another clear manifestation of this switch from optimism to pessimism can be seen in the inventories and orders figures. The inventory/sales ratio usually peaks early in the recession, then declines gradually but steadily during the later stages of recession and first months of recovery, and then stays at the trough level for at least a year or two, sometimes remaining there until the beginning of the next cyclical decline.

Yet this pattern has been badly distorted in the current recession period. The I/S ratio did decline from 1.54 in January to 1.46 in May, but then started back up again, climbing to 1.52 in August, as shown in Figure I; note in particular that the wholesale and retail trade I/S ratio are particularly high. Nor was this rise due solely to the slump in sales. Inventory stocks, after declining from $516 billion in January to $510 billion in May, turned around and increased to $515.6 billion in August, although admittedly some of that gain represents inflation.

FIGURE I



To a certain extent one can only sit and wonder at anyone's decision process which would permit inventory stocks to accumulate with real rates of interest near 10% and any recovery a mere promise rather than a fact. But nonetheless that is what did happen, and we can only attribute it to the widespread impression that the economy would indeed undergo robust growth in the second half.

Now that it is clear that nothing of the sort will happen, we must go through almost another complete inventory decumulation cycle, as the I/S ratio must fall from 1.52 to 1.40 before liquidation is complete -- a process which will probably take until February or March of 1983. To translate this into dollar terms implies some forecast about the underlying trends in sales. A reasonable estimate is that nominal sales will increase at a 6% annual rate over the next two quarters, which is to say from $345 to $361 billion. Then inventory stocks would have to decline to $505 billion from their August level of $515.6 billion, or more than a $10 billion reduction. IVA over the same period will probably be about $10 billion, which means NIPA inventory disinvestment of about $20 billion will have to take place over the next several months.

Whether this takes two, three, or even four quarters, this $20 billion reduction in inventories will put a tremendous damper on growth and production during the next several months. It now seems very unlikely that inventory reduction will be over by the end of this year, and hence both of the two essential criteria for the ending of any recession -- inventory liquidation and a sufficient decline in interest rates -- still remain unmet.

Fixed Investment To Weaken Further

The standard rule of thumb for recoveries states that once interest rates decline, housing turns up three months later, consumption six months later, and capital spending one year later. Thus even if the optimists on consumer spending turn out to be correct, we would see no upturn in capital spending until mid-1983. As it is, we may see no upturn in this sector at all next year. The investment anticipations for 1982 have finally declined to -4.4% and could well continue lower, as shown by the disappointing drop in August new orders for nondefense capital spending.

The investment anticipations have lagged far behind actual developments this year, as shown in the following brief table. The December figures shown there actually are extrapolated from anticipations for the first half of 1982, and hence are not true survey results -- although given that most expected a robust 1982 at the time, they probably underestimate what a full-year survey would have shown. By March, however, the BEA anticipations are usually an accurate guide to the actual numbers; 1982 apparently represents the largest single error ever in that series (we won't know for certain until the year is over). By comparison, the EEI figures for March correctly gauged the magnitude of capital spending weakness, and in fact may have even overestimated the actual decline this year.

This substantial gap between what corporations said they would do and what actually occurred is yet another piece of evidence that the business community was unprepared for the second half weakness. Once burned, they are likely to become extremely shy about increasing capital spending until conclusive evidence is at hand that the rest of the economy is improving. That will not be for another year at the earliest.

PREDICTED PERCENTAGE CHANGE IN INVESTMENT BY

Date of Prediction	EEI		BEA	
	Cur $	Const $	Cur $	Const $
December 1981	5.3	-1.2	11.3	2.6
March 1982	1.6	-5.6	7.3	-1.0
June 1982	0.7	-4.7	2.2	-2.4
September 1982	1.3	-4.1	0.7	-4.4

Turning to residential construction, it is a little too early to tell whether the decline in interest rates will lead to any pickup in housing starts. Last fall, rates started down in September, but the bulk of the decline occurred in October and November. Permits rebounded in December while starts did not pick up until February. Hence we would not expect any significant positive reaction to lower rates in the housing industry until the fourth quarter.

Having said this, the plunge in both housing starts and permits in August does not bode well for that sector, since it indicates to us that cost rather than financial considerations continue to dominate the housing industry. The ratio of the average monthly payment to household disposable income now stands at 32% -- 30% even with price discounting through creative financing -- compared to the 1947-1970 average of 20%. As a result, housing starts are expected to average only 1.1 million next year. Furthermore, we would not expect much improvement in this figure even if interest rates were to stay at current levels throughout 1983, since the imbalance in that industry is primarily on the cost side. A decline in mortgage rates will bring about a flurry of refinancing activity, as opposed to little improvement in new construction activity. Builders, like consumers and businessmen generally, are now more worried than ever that any decline in interest rates is likely to be temporary, which means that the houses started now at lower interest rates could not be sold because rates would have risen again by the time they were finished.

More Trouble Ahead For Foreign Trade

Finally, we should not close out this section without a brief commentary on the August foreign trade figures, which soared to a record one-month $7.1 billion deficit. These figures do not get as much publicity as most of the other government releases, partly because they are virtually unpredictable, partly because they are very erratic and subject to much wider monthly swings and revisions than most other monthly numbers, and partly because of a misplaced belief that the foreign sector is not quite as important as domestic activity. However, a $1 billion swing in net exports has just as much effect as a $1 billion in domestic consumption or investment, and considering the outcry being raised over higher imports of manufactured goods, this sector certainly deserves at least a brief mention.

We will start by offering the usual caveats. The seasonal factors are, as usual, screwed up. Imports reportedly declined $2.1 billion in July; hence about half of the $3.3 bilion surge in August is misplaced. Last year the net trade balance declined from -$1.8 billion in July to -$5.4 billion in August, and then rose again to -$2.8 billion in September. The August deficit is significantly overstated.

Yet to concentrate on these blips and ignore the underlying trends would in our opinion be a serious mistake. The great strength of the dollar is beginning to take its toll, both in terms of lessened exports and increased imports, although of course the world recession also contributes to weak exports. Some Administration clowns think they have to put a good face on everything; the sharp rise in imports, they said, was evidence that the economy was turning around, presaging an increase in domestic demand. In fact, almost half of the August increase in imports came in machinery, hardly the leading edge of any recovery. For those intent on gleaning what useful information exists in these figures, as opposed to making up excuses why they were not really so bad after all, the numbers are very disquieting.

The net trade deficit will probably return to the $3½-$4 billion range in September, and perhaps the August figure will be quietly forgotten. But the spectacular change in purchasing power parities over the past two years without the accompanying shift in cost performance is not so easily ignored. Since the trough in 1980.3, the value of the dollar has increased 26% relative to strong foreign currencies and 35% on a trade-weighted average basis. Thus net exports will continue to weaken during 1983 as the lagged effects of the stronger dollar become more significant. We look for a reduction in net exports of merchandise from -$22 billion last quarter to -$32 billion by the end of 1983.

The theory of international trade suggests that these higher values of the dollar, while admittedly helping other nations export more initially, should eventually hurt them because it induces a higher rate of imported inflation. After all, the U.S. experience during the 1977-1980 era serves as Exhibit A, when Blumenthal's infamous "a weak dollar is good for America" was one of the reasons for double-digit inflation by the end of the Carter presidency.

However, we see virtually no evidence of this pattern working in reverse. The inflation rate in the U.S. has fallen from 13.5% in 1980 to an estimated 6.3% this year; everyone agrees this is real progress although not all support the means used to accomplish it. But other countries have had almost as much improvement despite weakened currencies. In the U.K., for example, the rate of inflation has fallen from 18.0% in 1980 to an estimated 9.6% this year. In Japan, where the yen has been devalued from 225 to approximately 270 per dollar, the inflation rate has declined from 8.0% in 1980 to an estimated 3.1% this year. The inflation rate in Germany has not diminished, but it has remained at 5%.

It is true that performance has not been outstanding in other countries. In France, for example, inflation remains above 12%, but that is because of the initially inflationary policies of Mitterand — and even these have been reversed after only a few months of trial. The Canadian inflation rate also continues to worsen. Yet when fiscal and monetary policy have remained tight, inflation has declined as much in countries with depreciating currencies as it has in the U.S. with its rapidly appreciating currency.

This all harkens back to a point which I first made in an international forecast in 1973, when Laffer and his bunch were trying to peddle the theory that the weak dollar would lead to more inflation in the U.S., which indeed happened to occur. Our point at that time, which is equally valid today, is that the elasticities of imported inflation vary greatly depending on the state of the domestic economy in general and fiscal and monetary policy in particular. If the country in question treats devaluation as an unpleasant mistake, as something which is "not their fault" and tries to offset it by restoring purchasing power to those harmed by devaluation through cost-of-living increases and other similar mechanisms, then of course higher domestic rates of inflation will result. On the other hand, if the government treats devaluation as a sign that firm discipline is needed at home to control inflationary excesses -- or if it treats it as a subtle but effective tool to switch production from domestic to export markets -- then very little if any of the higher cost need be passed along in the form of higher domestic prices.

Hence the argument about devaluations is not necessarily symmetrical. A weaker U.S. dollar led to higher inflation and hence no improvement in our competitive posture during the 1977-1980 period because of the inchoate monetary and fiscal policies of the period. However, the stronger dollar does not necessarily mean higher inflation or lack of improvement in competitive posture for Germany and Japan -- since their monetary and fiscal policies are better balanced. Some countries, notably France and Canada, will not gain an export edge in spite of weaker currencies because internal inflation will accelerate. But that will not be the case for our major trading partners, and hence the strong dollar will continue to put greater pressure on our net trade position.

Optimal Fiscal Policies For The 1980's

I have long been associated with the general thrust of supply-side economics, which is to say I favor reduction of high marginal tax rates which impede saving and investment, productivity, and work effort and individual incentive. I still believe that the economy suffers from current high marginal tax rates.

It is equally clear, however, that the economic programs of the Reagan Administration have been a dismal failure. While the rate of inflation is down, so are real incomes. Most consumers are far worse off now than they were two years ago. The mounting budget deficits have led to a lack of saving, higher interest rates, and the decimation if not destruction of many of our basic industries. In my opinion, continuing present programs would promise more of the sme for the indefinite future.

Yet reversing the Reagan programs entirely would, in my opinion, be throwing the baby out with the bathwater. The problem is not in the reduction of high marginal tax rates per se. The problem is that these tax cuts were not balanced by spending cuts. While tax receipts grew only 1.8% in FY 1982, total Federal government spending rose 10.7%. The primary reason why the Kennedy-Johnson tax cuts worked so well was that government spending rose only 1% in FY 1965. I have no doubts that the Reagan program would have been quite successful if government spending had increased only 1% in the year just ended, but that turned out to be politically impossible.

Indeed, further cuts in government spending over the next two years seem just as unlikely as ever. A gradual program of raising the retirement age for social security benefits, ending the overindexation of entitlements, phasing in the increase in defense spending more gradually, and providing some sort of indexed bonds makes a great deal of sense to me but evidently not to any elected representatives in the U.S. Congress. Hence we turn our attention to the question of how to raise taxes without increasing the high marginal tax rates which damaged growth and productivity during the 1970's. The solution to this problem, I would submit, is a modified flat rate income tax.

The arithmetic of the flat rate tax is actually quite straightforward and consists of two issues. First, the rate at which the flat tax would have to be set to generate an equal amount of revenue ex ante -- i.e., before taking into account all the beneficial aspects of the flat tax. Second, how the changing tax burden would fall on the income distribution scale. For it is immediately obvious that if the tax is to raise the same amount of revenue, and some people pay less tax, others will have to pay more. A tax increase which falls disproportionately on those with less than median income will prove to be much less popular than one which somehow avoids this blemish.

According to Joint Tax Committee calculations, the average tax rate -- calculated as actual income tax paid divided by taxable income -- was 24.6% in 1980, as shown in Table 2. By 1984 it will be reduced to 22.3% as a result of the 25% across-the-board reduction in personal income tax rates. It is quite obviously that a reduction from 24.6% to 22.3% is more like a 10% rather than a 25% cut, but that is bracket creep in action. Without the tax rate cut, the average tax rate would have risen to approximately 28.3% for the same tax rate schedule.

According to our forecasts, personal income in 1984 will be $2976 billion and Federal personal income taxes will be $311 billion. Our forecast is more pessimistic than most, but that really doesn't affect the average tax rate; under a more buoyant scenario, both figures would be more or less proportionately higher. Thus under the very simplest calculation of all, the flat tax rate would be 10.45%, which we could round down to 10% without doing great violence to either the concept or the arithmetic.

TABLE 2

	1980	1981	1982	1983	1984	Flat 1984
Personal Income	2160	2415	2578	2765	2976	2976
Less: Transfer payments, untaxed	276	312	345	370	390	0
Less: Fringe benefits, untaxed	127	140	154	170	187	(187)
Less: Unreported income	151	174	200	230	265	(265)
Equals: Adjusted Gross Income	1606	1789	1879	1995	2134	2524
Less: AGI on nontaxable returns	59	59	59	59	59	0
Medical deduction	12	13	14	14	14	0
Tax deduction	67	73	80	88	97	0
Interest deduction	85	106	121	133	141	0
Charitable deduction	25	27	29	31	33	0
Other itemized deductions	15	16	17	18	19	0
Personal exemptions	186	190	194	197	201	592
Zero bracket, net	126	130	134	138	142	0
Tax credits	27	28	29	30	31	0
Equals: Taxable Income	1004	1147	1202	1287	1397	1932
Income tax	247	288	291	289	311	311
Average tax rate	24.6	25.1	24.2	22.5	22.3	16.1

All figures in billions of dollars

Source: 1980, Joint Tax Committee; 1981-1984, EEI estimates

Even those who favor the flat rate tax agree that the poorest should not have to pay any income tax; the usual solution is to allow a personal exemption, which could be the $1,000 currently allowed, or some larger amount to offset the fact that few if any deductions will remain. Our calculations assume a $2,500 personal exemption.

A second issue is the calculation of unreported income. One could indeed make a case that at very low marginal tax rates, less income would go unreported; we certainly have no quarrel with that concept. However, for purposes of calculating the ex ante rate needed to produce the same revenue, it seems more conservative to assume that unreported income remains the same, and then calculate the benefits later. In that case, we would subtract the Joint Tax Committee estimate of unreported income from total personal income.

Third, the question of how to treat untaxed fringe benefits -- mainly employer contributions for health and life insurance and pension plans -- remains a sticky one in the flat tax calculations. Some bills have specifically assumed that these benefits would be included in taxable income, and the Treasury calculations have also assumed this. However, in our more conservative calculations we have also excluded them from the taxable income base.

With these three adjustments -- $2,500 personal exemption, no reduction in unreported income, and fringe benefits remaining untaxed -- we calculate that a flat rate tax of only 16.1% would produce the same ex ante revenue in 1984.

If fringe benefits are taxed, that would drop the flat tax rate from 16.1% to 14.7%. If we furthermore assume that 2/3 of unreported income would then be reported, as discussed in the economics section, then the rate would drop further to 13.5%.

One of the biggest arguments thus far has been whether the deductions for medical care, for state and local taxes, for home mortgage interest, and for charities should remain intact. It turns out, at least on an arithmetic basis, not to make all that much difference. Continuing all of these deductions would reduce the taxable base by some $238 billion in 1984 (home mortgage interest is about 2/3 of total interest deductions). This would raise the flat rate tax from 16.1% to 18.4%, perhaps not an unduly high price to pay for obtaining the widespread political support necessary for the other, beneficial aspects of the bill. Furthermore, if one wanted to "trade" keeping these deductions for taxing fringe benefits, as indeed some have proposed, the flat tax rate would then rise only to

16.5%. It is clear that whether one keeps certain deductions or not is a matter of equity, but not one of arithmetic. Every $100 bilion change in the taxable income base only changes the flat tax rate by about 1%.

We now turn to the effect of the flat rate tax on individual taxpayers. Right at the outset we must state that no unequivocal answer is possible; it depends on one's present deductions and exactly what form the flat rate tax will take. For this reason we have calculated the tax due for flat rates ranging from 17% down to 14%. To keep the exposition manageable, however, we will concentrate on the 16% rate.

Within this range, the basic profile shows that taxes are slightly higher for the middle class and much lower for the upper class. However, this is somewhat of a mirage in the sense that the upper-income taxes are calculated using the standard rule of deductible expenses equal to 23% of gross income; this assumes no further tax avoidance, which clearly is not the case. Indeed, fragmentary estimates suggest that many upper income people pay about 20% of their actual income in taxes, which is not far different from what would be the case under the flat rate tax. The incentive and tax avoidance results would be quite different, but we leave that part of the discussion to the economics section.

Under the 16% flat rate tax, the average family of four with an income under $18,000 would benefit, providing that we exclude the effect of the income tax credit for very poor families. At $10,000 per year, this family would owe no taxes at all, compared to $283 under present law. At $15,000, taxes would be reduced by $136 per year.

As we move into the middle-income brackets, the 16% flat rate tax would slightly increase the tax bill for the average family. At $20,000, for example, taxes would be some $69 per year higher in 1984 than under current law, although this is still $413 less than would have been paid had there been no tax cut at all.

For the $25,000 family, taxes would be $173 higher; for the $30,000 family, $169 higher; and for the $40,000 family, $81 higher. Above that, taxes are lower with the flat rate, providing that the family in question does not currently shelter very much of their income. All these figures are given in Table 3.

A tax increase for the $18,000 to $40,000 families, even if slight, may not prove to be very popular politically. However, as a matter of simple arithmetic it stands to reason that if taxes are going to be lower at the upper end of the scale, then they will be higher somewhere else. One way around this dilemma would be to lower the flat rate to 14%, in which case taxes would be lower for virtually all families (although not for single individuals), based on the argument that the amount of unreported income at a 14% tax rate is likely to decline dramatically. As we have already pointed out, taxing fringe benefits and assuming that 2/3 of unreported income would be reported would permit dropping the flat tax rate to 13.5%. In that case, however, the tax would not be much of a revenue raiser.

TABLE 3A
EFFECT OF A FLAT RATE TAX
FOR
FOUR-PERSON FAMILY, VARIOUS INCOME LEVELS
(dollars)

Wage Income	Without The Reagan Tax Cut[1]	With 25% Tax Rate Cut[2]	Flat Rate Tax Of			
			17%	16%	15%	14%
5,000	-500	-500	0	0	0	0
10,000	374	283	0	0	0	0
15,000	1,233	936	850	800	750	700
20,000	2,013	1,531	1,700	1,600	1,500	1,400
25,000	2,901	2,227	2,550	2,400	2,250	2,100
30,000	3,917	3,031	3,400	3,200	3,000	2,800
40,000	6,312	4,881	5,100	4,800	4,500	4,200
50,000	9,323	7,228	6,800	6,400	6,000	5,600
100,000	27,878	22,154	15,300	14,400	13,500	12,600
200,000	66,378	57,399	32,300	30,400	28,500	26,600

Source: Office of the Secretary of the Treasury
Office of Tax Analysis

[1] Assumes deductible expenses equal to 23% of gross income.

[2] Existing low

TABLE 3B

A FLAT RATE TAX EFFECT OF THE ADMINISTRATION'S PROPOSED FOR SINGLE INDIVIDUAL, VARIOUS INCOME LEVELS

(dollars)

Wage Income	Without the Reagan Tax Cut[1]	With 25% Tax Cut Rate[2]	Flat Rate Tax Of			
			17%	16%	15%	14%
5,000	250	188	425	400	375	350
10,000	1,177	873	1,275	1,200	1,125	1,050
15,000	2,047	1,565	2,125	2,000	1,875	1,750
20,000	3,115	2,381	2,975	2,800	2,625	2,450
25,000	4,364	3,341	3,825	3,600	3,375	3,150
30,000	5,718	4,391	4,675	4,400	4,125	3,850
40,000	8,886	6,826	6,375	6,000	5,625	5,250
50,000	12,559	9,682	8,075	7,600	7,125	6,650
100,000	31,792	26,814	16,575	15,600	14,625	13,650
200,000	70,292	64,976	33,575	31,600	29,625	27,650

Source: Office of the Secretary of the Treasury
Office of Tax Analysis

[1] Assumes deductible expenses equal to 23% of gross income.

[2] Existing low

The flat rate tax which I propose would have the following fetures:

1. The basic flat rate tax should be set low enough so that, based on the standard tax tables, most taxpayers who did not previously have unusually high deductions will pay less tax. That would mean that the basic flat rate would be set at 15% or 16%.

2. The basic deductions -- home mortgage interest, charitable contributions, catastrophic medical expenses, and state and local taxes -- would be retained.

3. An end to the miscellaneous deductions, particularly those which lead to so-called abusive tax shelters. To a certain extent this also involves accelerated depreciatio schedules and tax credits for capital expenditures, providing we also have integration of the personal and corporate tax schedules.

4. The increased revenues necessary should come from either (a) taxing fringe benefits, (b) taxing social security and other retirement benefits, or (c) keeping some graduated feature of the income tax rate schedule.

How The Flat Rate Tax Can Balance The Budget

Considering that we have chosen the rate of the flat tax to equal the ex ante revenues generated from current tax laws, our headline claim may seem not only grandiose but akin to the alleged alchemy of the Laffer curve. However, we have calculated that a flat rate tax of 16% would bring in $150 billion more per year in 1984 than the current tax structure, with the gap widening in each successive year. The details are found in Table 4.

Some of these calculations are quite straightforward. For example, taxing fringe benefits would bring an additional $30 billion into the Treasury coffers. The other calculations, however, require some assumptions about the various elasticities of response to lower tax rates.

We have estimated that approximately 2/3 of currently unreported income and tax avoidance income would be reported at a flat rate tax of 16%. To a certain extent this simply represents straight proportionality since top marginal rates are now at 50%; our figures exclude any income generated from illegal sources.

We do have some additional evidence, however, other than simple straight-line extrapolation. According to IRS testimony last March, during the period from 1973 to 1981 the average marginal tax rate grew from 27.6% to 35.0%. Over the same period, according to IRS estimates, unreported income grew about 5% per year, or 40% faster than reported income. Using the elasticity implied in those numbers means that a reduction in the average marginal rate from 35% to 16% would result in only 27% of currently reported legal source income remaining unreported; this also implies that all legal source income would be reported at a 10% marginal tax rate. Hence our figure of 1/3 is rather conservative.

TABLE 4

EFFECT OF FLAT RATE TAX ON FEDERAL TAX RECEIPTS

	Current Law	17%	16%	15%	14%
Ex Ante Revenue	311	328	309	290	270
Taxing Fringe Benefits		32	30	28	26
2/3 Unreported Income		45	42	40	37
2/3 Tax Avoidance		52	49	46	43
Total	**311**	**457**	**430**	**404**	**376**
Supply-Side Effects Increase In Growth Due To					
Greater work effort		14	15	15	16
Greater capital funds		8	8	9	9
Higher productivity from other sources		7	7	7	7
Total Supply-Side Effects		**29**	**30**	**31**	**32**
TOTAL PERSONAL INCOME TAXES		**486**	**460**	**435**	**408**

Table 4 also indicates the magnitudes of the increases which would occur from supply-side effects: greater work effort, greater capital formation, and other improvements in productivity. These are based on the elasticities in the supply-side model. A reduction in the average marginal tax rate on labor income from 31% to 16% would raise work effort by 3%, which would increase GNP by 2%. Since tax receipts are approximately 20% of total GNP, this would raise total tax receipts by 0.4% of GNP, or about $15 billion at 1984 levels of GNP.

The average marginal tax rate for saving would decline from 43% to 17%, which would increase the aftertax rate of return from 0.84% to 3.96%, assuming a 12% interest rate and 6% inflation rate. This would increase the personal saving rate by about 3%, which would eventually raise capital stock by 3%. This in turn would increase GNP by 1%, so that tax receipts would rise by about $8 billion. We also calculate that the reduction in tax rates would raise productivity by an additional 1% in addition to the gains associated with higher labor and capital inputs. Hence real GNP would be about 4% higher than would be the case in the absence of the flat rate tax cut. This process would probably happen over a three to five year period, representing an increase of approximately 1% per year in the overall growth rate.

The net effect of all these changes -- taxing fringe benefits, less unreported income, less use of tax shelters, and the supply-side effects -- would be to raise tax revenues by $150 billion in 1984 and more in later years. This would essentially lead to a balanced budget -- even if the supply-side effects are minimal. If they are really much more substantial than we have estimated, the budget would actually be in surplus, and the flat rate tax could be cut even further. But we are trying to keep the claims for the flat rate tax within the bounds of reasonableness.

The demand-side effects are somewhat mixed, at least initially. We must bear in mind that a $120 billion increase in taxes (excluding supply-side effects) means that someone will be paying $120 billion more in taxes, and the fact that much of this will come from heretofore unreported and tax-sheltered income does not diminish the fact that this will be quite a jolt in reduced purchasing power. In the absence of any offsetting factors, this would reduce consumption by about $30 billion the first year and $60 billion per year after three or four years.

Of course the offsetting factors will be enormous. With the budget and savings flows once again essentially in balance, interest rates would return to their historical parity with inflation, which means short-term rates 0% to 1% above the rate of inflation, and long-term rates 2% to 3% above inflation. With the current amount of unused capacity and excess resources, we would expect no inflationary effect at all; indeed, with lower tax rates, the net effect should be to reduce inflation even further. Thus long-term interest rates should fall about 6% from current levels, which would raise real GNP by about 2½% after taking into consideration the usual lag of a year or two. With GNP in 1984 expected to be about $3600 billion in 1984, that would increase investment and interest-sensitive sectors of consumption by about $90 billion, easily offsetting the $30 billion to $60 billion decline in consumption which would have occurred in the absence of lower interest rates. Thus on balance the demand-side factors would raise real GNP growth rates by 1% to 2% per year, meshing nicely with the 1% annual increase in aggregate supply which would be brought about through lower tax rates.

This could be just another pipe dream which would disappear much as did the Reagan program promulgated with so much fanfare in early 1981 -- but we don't think so. The flat rate tax cut is not by any stretch of the imagination being proposed as another tax reduction -- indeed it is a revenue raiser. However, it reduces high marginal tax rates at the same time it raises the average tax rate.

Thus unlike the Reagan three-year 25% across the board cut in personal income tax rates, which turned out to be balanced only by thin air, the economy will not head further into the depths of triple-digit deficits and double-digit real rates of interest. The middle class American will not receive a tax cut on an ex ante basis, but his real income will rise and the decline in interest rates from the reduced budget deficits will be worth far more to him than was the Reagan tax cut — according to our estimates, about twice as much.

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TABLE 1.1 - MAJOR ECONOMIC INDICATORS

VARIABLE NAME	1982.2	1982.3	1982.4	1983.1	1983.2	1983.3	1983.4	1984.1	1984.2	1984.3	1984.4	1982	1983	1984
GROSS NATIONAL PRODUCT	3045.2	3092.7	3134.7	3199.9	3258.4	3305.0	3367.5	3434.9	3524.9	3610.9	3703.0	3067.[illegible]	3282.7	3568.4
GROSS NATIONAL PRODUCT, 1972 $	1478.4	1475.1	1474.4	1482.0	1487.2	1487.6	1493.8	1505.2	1525.2	1543.0	1559.3	1474.6	1487.6	1533.2
INDEX OF INDUS PRODUCTION,TOTAL	139.3	137.9	137.8	139.7	140.8	140.7	142.1	144.3	147.1	150.5	153.6	139.2	140.8	148.9
CONSUMPTION EXPENDITURES	1947.8	1989.9	2034.0	2057.4	2087.5	2122.4	2164.7	2202.7	2249.2	2294.5	2342.6	1972.9	2108.0	2272.3
DURABLE GOODS	240.7	239.1	247.2	245.5	241.1	237.1	237.2	243.8	253.9	261.2	266.3	241.2	240.2	256.3
AUTOMOBILES AND PARTS	103.3	102.9	107.2	107.9	105.4	103.5	102.3	107.8	115.2	120.5	122.6	104.2	104.8	116.5
OTHER DURABLE GOODS	137.4	136.2	140.0	137.5	135.7	133.6	134.9	136.0	138.7	140.7	143.8	137.1	135.4	139.8
NONDURABLE GOODS	755.0	771.4	784.9	790.9	802.3	822.2	840.5	850.4	863.1	877.8	894.2	765.1	814.2	871.4
SERVICES	952.1	979.3	1001.9	1021.0	1043.1	1063.1	1087.2	1108.6	1132.2	1155.5	1182.1	966.4	1053.6	1144.6
NEW CAR SALES, SAAR	7.4	7.8	8.3	8.7	8.5	8.3	8.2	8.5	8.9	9.1	9.3	8.0	8.4	9.0
RETAIL SALES	267.0	266.9	273.3	272.8	273.2	274.9	279.0	283.0	289.3	294.8	300.7	266.8	275.0	292.0
GROSS PRIVATE INVESTMENT	431.5	423.6	406.9	438.8	454.5	452.6	451.1	465.6	494.1	524.5	552.4	419.2	449.2	519.2
FIXED INVESTMENT	447.7	443.8	443.6	449.4	451.5	452.0	453.7	468.0	489.4	511.2	532.3	446.4	451.7	500.2
NONRESIDENTIAL	352.2	347.9	345.4	344.0	344.4	342.5	345.0	345.6	360.6	372.9	388.5	350.6	344.0	367.9
STRUCTURES	143.6	141.3	139.8	137.9	136.7	133.9	134.0	136.1	140.5	144.7	149.9	141.5	135.6	142.8
EQUIPMENT	208.6	206.6	205.6	206.2	207.7	208.6	211.0	213.5	220.1	228.2	238.7	209.1	206.4	225.1
RESIDENTIAL STRUCTURES	95.5	95.9	98.2	105.4	107.1	109.5	108.7	118.4	128.8	138.2	143.8	95.8	107.7	132.3
CHANGE IN INVENTORIES	-16.2	-20.2	-36.7	-10.6	3.0	0.6	-2.6	-2.3	4.7	13.4	20.1	-27.2	-2.4	9.0
TOTAL PRIVATE HOUSING STARTS	0.95	1.05	1.08	1.25	1.07	1.09	1.05	1.37	1.48	1.50	1.51	1.00	1.12	1.47
NET EXPORTS, GOODS AND SERVICES	34.9	34.3	31.6	28.4	27.8	28.0	30.8	32.6	33.1	30.9	29.4	33.[illegible]	28.8	31.5
EXPORTS	365.6	368.4	370.6	374.4	362.8	392.2	402.9	413.9	424.6	435.0	445.3	366.[illegible]	388.1	429.7
IMPORTS	330.9	334.1	338.9	345.9	355.0	364.2	372.1	381.3	391.5	404.1	415.9	333.1	359.3	398.2
GOVERNMENT PURCHASES	630.9	644.9	662.1	675.3	688.6	702.0	720.6	734.0	748.5	761.0	778.6	642.0	696.6	755.5
FEDERAL	244.3	251.7	263.8	270.7	277.6	284.5	296.7	303.5	311.5	317.6	328.7	252.4	282.3	315.3
NATIONAL DEFENSE	176.2	181.5	191.3	197.3	203.3	209.3	219.1	225.1	232.1	237.1	247.2	179.8	207.2	235.4
OTHER	68.2	70.2	72.5	73.4	74.3	75.2	77.5	78.4	79.4	80.4	81.5	73.6	75.1	79.9
STATE AND LOCAL	386.6	393.2	398.3	404.6	411.0	417.5	424.0	430.5	436.9	443.4	449.9	389.6	414.3	440.2
FEDERAL GOVT SURPLUS OR DEFICIT	-119.6	-145.0	-155.6	-144.9	-155.5	-190.5	-199.0	-187.4	-185.2	-187.5	-187.9	-134.7	-172.5	-187.0
PERSONAL INCOME	2552.7	2603.5	2642.9	2685.1	2733.8	2782.9	2833.1	2880.3	2935.4	3001.0	3065.1	2577.4	2758.7	2970.4
DISPOSABLE PERSONAL INCOME	2151.5	2206.7	2239.0	2278.0	2326.4	2391.3	2432.4	2466.1	2511.1	2565.8	2617.6	2178.6	2357.0	2540.1
CORP PROFITS BEFORE TAXES	171.7	173.4	168.2	173.8	183.3	178.9	173.6	187.2	209.6	226.4	234.8	171.2	177.4	214.5
CORP PROFITS AFTER TAXES	116.3	115.0	111.6	106.5	112.5	108.0	102.6	110.8	127.0	134.3	143.2	114.7	107.4	129.8
CAPACITY UTILIZATION, PCT	72.6	71.5	71.1	72.0	72.3	71.8	72.1	72.6	74.0	75.1	75.8	72.4	72.0	74.4
UNEMPLOYMENT RATE	9.5	9.9	10.1	10.2	10.3	10.4	10.6	10.6	10.4	10.3	10.1	9.6	10.4	10.3
SAVING RATE	6.7	7.1	6.5	7.0	7.6	8.6	8.4	8.1	7.9	8.1	8.0	6.7	7.9	8.0
IMPLICIT GNP DEFLATOR	206.0	209.7	212.6	215.9	219.1	222.2	225.4	228.2	231.1	234.0	237.5	208.0	220.7	232.7
CONSUMER PRICE INDEX	286.8	292.3	295.2	299.6	305.0	309.1	312.9	315.7	319.4	323.3	327.7	289.1	306.7	321.5
PRODUCER PRICE INDEX, TOTAL	298.7	298.9	300.7	303.4	306.6	309.9	313.0	317.1	321.7	326.6	330.7	299.1	308.2	324.0
PRODUCER PRICE INDEX,FINISH GDS	278.3	281.8	285.6	288.2	291.6	295.5	299.1	303.4	307.4	311.9	315.7	280.8	293.6	309.6
PRODUCER PRICE INDEX, IND COMM	310.0	311.6	313.8	316.7	320.8	324.4	327.8	332.0	337.1	342.3	346.9	311.7	322.4	339.6
MONEY SUPPLY, M1	451.8	456.1	466.0	470.4	474.2	478.4	484.5	490.1	496.5	503.2	510.0	455.5	476.9	500.0
MONEY SUPPLY, M2	1895.7	1944.0	1977.8	2011.1	2058.1	2091.5	2120.9	2157.7	2199.1	2240.8	2286.3	1917.2	2070.4	2221.0
FEDERAL FUND RATE	14.51	11.04	10.48	12.00	13.03	11.58	9.73	8.91	8.81	8.92	9.31	12.56	11.59	8.96
TREASURY BILL RATE, 91-DAY	12.42	9.57	7.35	9.33	10.39	9.66	8.90	8.34	8.10	8.28	8.73	10.54	9.58	8.36
COMM PAPER RATE, 4-6 MONTH	13.48	11.53	10.72	12.36	13.58	11.89	10.07	9.36	9.42	9.55	9.88	12.36	11.97	9.55
PRIME COMMERCIAL BANK RATE	16.50	14.81	12.91	14.07	15.45	14.31	12.72	11.85	11.74	11.86	12.16	15.12	14.13	11.90
AAA CORP RATE	14.50	13.94	12.47	13.84	14.37	13.54	12.96	12.68	12.55	12.54	12.56	13.97	13.67	12.58

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VARIABLE NAME	1982.2	1982.3	1982.4	1983.1	1983.2	1983.3	1983.4	1984.1	1984.2	1984.3	1984.4	1982	1983	1984
TABLE 2.1 - MAJOR ECONOMIC INDICATORS, PRODUCT AND INCOME (PERCENT CHANGE, ANNUAL RATES)														
GROSS NATIONAL PRODUCT	6.8	6.4	5.5	8.6	7.5	5.8	7.8	8.3	10.9	10.1	10.6	4.4	7.0	8.7
GROSS NATIONAL PRODUCT, 1972 $	2.1	-0.9	-0.2	2.1	1.4	0.1	1.7	3.1	5.4	4.8	4.3	-1.9	0.9	3.1
INDEX OF INDUS PRODUCTION,TOTAL	-6.8	-3.8	-0.4	5.5	3.4	-0.3	3.9	6.6	7.9	9.5	8.5	-7.7	1.2	5.7
INDEX OF INDUS PRODUCTION, MFG	-4.9	-2.5	-1.4	6.6	3.8	-1.0	3.9	6.5	11.4	10.1	8.8	-8.2	1.5	6.4
CONSUMPTION EXPENDITURES	6.1	8.9	9.2	4.7	6.0	6.9	8.3	7.2	8.7	8.3	8.7	7.6	6.9	7.8
DURABLE GOODS	4.8	-2.6	14.1	-2.7	-7.0	-6.4	0.2	11.5	17.6	12.1	8.1	2.9	-0.4	6.7
AUTOMOBILES AND PARTS	0.4	-1.4	17.6	2.8	-9.2	-6.9	44.4	23.2	30.1	20.0	7.0	5.7	0.6	11.2
OTHER DURABLE GOODS	8.3	-3.4	11.5	-6.6	-5.3	-6.0	3.9	3.3	8.4	5.8	8.9	0.8	-1.2	3.2
NONDURABLE GOODS	3.2	9.0	7.2	3.1	6.4	9.7	9.2	4.6	6.1	7.0	7.7	4.2	6.4	7.0
SERVICES	8.7	11.9	9.6	7.8	9.0	7.9	9.4	8.1	8.8	8.5	9.5	10.6	9.0	8.6
NEW CAR SALES, SAAR	-35.1	25.2	23.9	19.3	-8.7	-6.1	-4.9	16.1	19.2	10.7	5.3	-7.6	5.8	6.6
GROSS PRIVATE INVESTMENT	17.1	-7.1	-14.9	35.2	15.1	-1.7	-1.3	13.5	26.8	27.0	23.0	-11.1	7.2	13.3
FIXED INVESTMENT	-2.4	-3.4	-0.2	5.3	1.9	0.4	1.5	13.2	19.6	19.0	17.6	-1.7	1.2	10.8
NONRESIDENTIAL	-5.3	-4.8	-2.8	-1.6	0.4	-2.2	3.0	5.4	13.2	14.4	17.8	1.3	-1.9	7.0
STRUCTURES	6.4	-6.2	-4.1	-5.6	-3.3	-7.9	0.2	6.4	13.6	12.7	14.9	9.1	-4.2	5.3
EQUIPMENT	-12.4	-3.8	-1.9	1.2	2.9	1.7	4.8	4.8	12.9	15.5	19.7	-3.4	-0.3	8.0
RESIDENTIAL STRUCTURES	9.3	1.8	9.7	32.6	6.9	9.2	-2.9	40.6	40.2	32.6	17.1	-8.8	12.5	22.9
EXPORTS	6.7	2.9	2.3	4.2	9.2	10.2	11.4	11.3	10.8	10.2	9.8	-0.3	6.0	10.7
IMPORTS	2.8	4.0	5.9	8.5	10.8	10.8	8.9	10.3	11.1	13.5	12.2	-2.4	7.8	10.8
GOVERNMENT PURCHASES	0.5	9.2	11.1	8.2	8.1	8.0	11.1	7.6	8.1	6.9	9.6	7.5	8.5	8.5
FEDERAL	-8.4	12.7	20.7	10.9	10.6	10.3	18.3	9.6	10.9	8.0	14.7	10.2	11.9	11.7
NATIONAL DEFENSE	26.3	12.7	23.2	13.2	12.7	12.3	20.2	11.4	13.0	8.9	18.1	16.3	15.9	13.6
OTHER	-55.5	12.0	14.3	5.0	4.9	4.9	13.0	4.7	5.1	5.3	5.2	-2.2	2.1	6.4
STATE AND LOCAL	6.7	7.0	5.3	6.4	6.5	6.4	6.3	6.3	6.2	6.1	6.0	5.9	6.3	6.3
PERSONAL INCOME	6.9	8.2	6.2	6.5	7.5	7.4	7.4	6.8	7.9	9.2	8.8	6.7	7.0	7.7
DISPOSABLE PERSONAL INCOME	6.7	10.7	6.0	7.1	8.8	11.6	7.1	5.7	7.5	9.0	8.3	7.4	8.2	7.6
DISPOSABLE PERS INCOME, 1972$	3.1	2.6	0.7	1.5	2.7	5.5	1.5	0.9	2.6	4.3	3.0	1.3	2.3	2.6
CORP PROFITS BEFORE TAXES	0.2	4.8	-11.5	13.9	23.7	-9.2	-11.3	35.1	57.4	36.1	15.7	-26.2	3.6	20.9
CORP PROFITS AFTER TAXES	1.4	-4.5	-11.3	-16.9	24.6	-15.0	-18.8	36.3	72.4	40.6	15.0	-24.0	-6.3	20.8
TABLE 2.2 - MAJOR ECONOMIC INDICATORS, PRICE AND MONETARY (PERCENT CHANGE, ANNUAL RATES)														
IMPLICIT GNP DEFLATOR	4.6	7.4	5.7	6.4	6.0	5.7	6.0	5.0	5.2	5.1	6.1	6.4	6.1	5.5
IMPLICIT CONSUMPTION DEFLATOR	3.6	7.8	5.3	5.6	5.9	5.8	5.4	4.7	4.8	4.5	5.2	6.5	5.8	5.1
CONSUMER PRICE INDEX	4.7	8.0	4.0	6.0	7.5	5.5	5.0	3.6	4.8	5.0	5.6	6.3	5.9	4.8
PRODUCER PRICE INDEX, TOTAL	0.5	0.3	2.5	3.6	4.3	4.3	4.0	5.4	5.9	6.3	5.1	1.5	3.0	5.1
PRODUCER PRICE INDEX,FINISH GDS	0.9	5.1	5.6	3.6	4.9	5.4	4.9	5.9	5.4	5.9	5.0	4.1	4.5	5.5
PRODUCER PRICE INDEX, IND COMM	-1.8	2.0	2.9	3.8	5.3	4.6	4.2	5.2	6.3	6.3	5.4	2.6	3.4	5.3
MONEY SUPPLY, M1	3.3	3.9	9.0	3.9	3.2	3.6	5.2	4.7	5.4	5.5	5.5	6.0	4.7	4.8
MONEY SUPPLY, M2	9.9	10.6	7.1	6.9	9.7	6.6	5.8	7.1	7.9	7.8	8.4	9.7	8.0	7.3

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TABLE 3.1 - GROSS NATIONAL PRODUCT IN CONSTANT DOLLARS

VARIABLE NAME	1982.2	1982.3	1982.4	1983.1	1983.2	1983.3	1983.4	1984.1	1984.2	1984.3	1984.4	1982	1983	1984
GROSS NATIONAL PRODUCT	1478.4	1475.1	1474.4	1482.0	1487.2	1487.6	1493.8	1505.2	1525.2	1543.0	1559.3	1474.[illegible]	1487.6	1533.2
CONSUMPTION EXPENDITURES	955.0	957.2	965.9	963.8	963.9	966.2	972.6	978.3	987.4	996.1	1004.2	956.8	966.6	991.5
DURABLE GOODS	138.3	135.9	139.6	136.9	132.9	129.0	128.3	130.3	133.9	136.4	138.3	137.6	131.8	134.7
AUTOMOBILES AND PARTS	54.4	53.4	55.7	55.5	53.4	51.6	51.0	52.8	55.3	56.9	57.6	54.[illegible]	52.9	55.6
OTHER	83.9	82.5	83.8	81.3	79.5	77.3	77.4	77.5	78.7	79.5	80.7	83.2	78.9	79.1
NONDURABLE GOODS	364.5	365.9	368.3	366.8	367.2	370.1	373.1	373.2	374.2	375.7	377.4	365.2	369.3	375.1
SERVICES	452.2	455.4	458.0	460.2	463.8	467.2	471.1	474.8	479.2	484.0	488.5	453.8	465.6	481.6
GROSS PRIVATE INVESTMENT	202.3	196.1	186.2	195.1	199.0	195.5	192.9	196.3	205.0	213.7	221.8	195.0	195.6	209.2
FIXED INVESTMENT	206.7	202.0	199.2	199.5	197.8	195.2	194.0	197.2	203.2	208.5	214.1	204.6	196.6	205.7
NONRESIDENTIAL	166.7	162.3	158.9	156.9	155.1	152.3	151.4	151.3	153.7	156.7	161.0	165.	153.9	155.7
STRUCTURES	53.7	52.4	51.3	50.0	48.8	47.1	46.6	46.7	47.4	47.9	48.6	52.7	48.1	47.7
EQUIPMENT	113.0	109.9	107.6	106.9	106.3	105.2	104.8	104.6	106.3	108.8	112.2	112.3	105.8	108.0
RESIDENTIAL STRUCTURES	40.1	39.8	40.1	42.7	42.7	43.0	42.6	46.0	49.5	51.8	53.1	39.7	42.7	50.1
NONFARM	37.0	36.8	37.1	39.5	39.4	39.7	39.2	42.5	45.9	48.2	49.4	36.7	39.4	46.5
FARM	1.1	1.1	1.1	1.2	1.2	1.2	1.2	1.3	1.3	1.3	1.3	1.1	1.2	1.3
PROD DURABLE EQUIP	1.9	1.9	1.9	2.0	2.0	2.1	2.1	2.2	2.3	2.3	2.3	1.9	2.1	2.3
CHANGE IN INVENTORIES	-4.4	-6.0	-12.8	-4.4	1.2	0.2	-1.0	-0.9	1.8	5.2	7.7	-9.7	-1.0	3.4
NONFARM	-3.8	-6.0	-12.8	-4.4	1.2	0.2	-1.0	-0.9	1.8	5.2	7.7	-9.6	-1.0	3.4
FARM	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.0
NET EXPORTS, GOODS & SERVICES	35.7	34.7	33.6	32.4	31.9	31.6	32.2	32.6	32.7	31.9	31.1	35.2	32.0	32.1
EXPORTS	154.4	153.9	153.2	153.1	154.4	156.1	158.2	160.4	162.4	164.3	166.0	153.3	155.4	163.3
IMPORTS	118.7	119.2	119.7	120.7	122.4	124.5	126.0	127.8	129.7	132.4	134.9	118.1	123.4	131.2
GOVERNMENT PURCHASES	285.3	287.1	288.7	290.7	292.3	294.3	296.0	298.0	300.1	301.4	302.2	287.6	293.3	300.4
FEDERAL	110.3	111.8	113.4	115.1	116.7	118.5	120.1	121.8	123.8	125.0	126.0	112.[illegible]	117.6	124.1
STATE AND LOCAL	175.0	175.3	175.3	175.6	175.7	175.8	176.0	176.2	176.3	176.4	176.3	175.1	175.8	176.3

TABLE 3.2 - IMPLICIT PRICE DEFLATORS FOR GNP

VARIABLE NAME	1982.2	1982.3	1982.4	1983.1	1983.2	1983.3	1983.4	1984.1	1984.2	1984.3	1984.4	1982	1983	1984
GROSS NATIONAL PRODUCT	206.0	209.7	212.6	215.9	219.1	222.2	225.4	228.2	231.1	234.0	237.5	208.[illegible]	220.7	232.7
CONSUMPTION EXPENDITURES	204.0	207.9	210.6	213.5	216.6	219.7	222.6	225.2	227.8	230.3	233.3	206.2	218.1	229.1
DURABLE GOODS	174.0	176.0	177.1	179.4	181.4	183.9	184.9	187.1	189.6	191.5	192.5	175.0	182.4	190.2
NONDURABLE GOODS	207.1	210.8	213.1	215.6	218.8	222.2	225.2	227.8	230.6	233.7	237.0	209.5	220.5	232.3
SERVICES	210.6	215.0	218.7	221.9	224.9	227.5	230.8	233.5	236.3	238.7	242.0	212.9	226.3	237.6
FIXED INVESTMENT	216.6	219.7	222.9	225.2	228.3	231.5	233.9	237.3	240.9	245.2	248.6	218.2	229.7	243.0
NONRESIDENTIAL	211.3	214.4	217.4	219.3	222.0	224.9	227.9	231.1	234.6	238.0	241.3	212.7	223.5	236.2
STRUCTURES	267.6	269.5	272.8	275.6	280.1	284.4	287.6	291.5	296.4	302.0	307.2	268.5	281.9	299.3
EQUIPMENT	184.6	188.0	191.0	192.9	195.4	198.3	201.3	204.1	207.0	209.8	212.6	186.4	197.0	208.4
RESIDENTIAL	238.6	241.3	244.7	247.0	251.0	255.0	255.3	257.7	260.5	266.9	271.0	241.3	252.1	264.0
NONFARM	242.1	244.9	248.4	250.6	254.7	258.9	259.3	261.5	264.1	270.5	274.7	244.9	255.9	267.7
FARM	242.0	244.7	248.2	250.5	254.5	258.6	258.9	261.3	264.2	270.7	274.8	244.7	255.7	267.8
PROD DURABLE EQUIP	168.1	170.0	172.4	174.0	176.8	179.6	179.9	181.5	183.5	188.0	190.9	169.0	177.6	186.0
EXPORTS	236.8	239.5	241.8	244.5	247.9	251.3	254.7	258.0	261.4	264.8	268.2	238.8	249.6	263.1
IMPORTS	278.8	280.4	283.2	286.6	289.9	292.0	295.3	298.3	301.8	305.2	308.4	282.2	291.1	303.4
GOVERNMENT PURCHASES	221.1	224.6	229.4	232.3	235.5	238.5	243.5	246.3	249.4	252.5	257.6	223.2	237.5	251.5
FEDERAL	221.6	225.1	232.7	235.1	237.9	240.0	247.1	249.3	251.7	254.0	260.9	224.4	240.0	254.0
STATE AND LOCAL	220.9	224.3	227.2	230.4	234.0	237.5	240.9	244.2	247.8	251.4	255.2	222.[illegible]	235.7	249.7
GOVT OUTPUT ORIG	205.7	209.2	213.9	216.0	218.4	220.6	226.4	228.6	230.8	232.9	238.4	207.9	220.4	232.7

EVANS ECONOMICS FORECASTING SERVICE
OCTOBER 11: THE FED LOWERS THE DISCOUNT RATE

VARIABLE NAME	1982.2	1982.3	1982.4	1983.1	1983.2	1983.3	1983.4	1984.1	1984.2	1984.3	1984.4	1982	1983	1984
TABLE 4.1 - GROSS NATIONAL PRODUCT IN CONSTANT DOLLARS (PERCENT CHANGE, ANNUAL RATES)														
GROSS NATIONAL PRODUCT	2.1	-0.9	-0.2	2.1	1.4	0.1	1.7	3.1	5.4	4.8	4.3	-1.5	0.9	3.1
CONSUMPTION EXPENDITURES	2.5	0.9	3.7	-0.9	0.0	1.0	2.7	2.4	3.7	3.6	3.3	1.0	1.0	2.6
DURABLE GOODS	2.3	-6.8	11.2	-7.5	-11.0	-11.4	-1.9	6.2	11.7	7.6	5.8	-1.6	-4.4	2.3
AUTOMOBILES AND PARTS	-3.6	-7.0	18.5	-1.4	-14.7	-12.5	-5.0	15.0	20.0	12.3	5.4	0.7	-3.2	5.2
OTHER	6.4	-6.7	6.7	-11.4	-8.5	-10.6	0.2	0.8	6.2	4.4	6.0	-3.1	-5.2	0.3
NONDURABLE GOODS	2.6	1.5	2.7	-1.7	0.5	3.2	3.4	0.1	1.1	1.6	1.8	0.8	1.1	1.6
SERVICES	2.4	2.9	2.3	1.9	3.2	3.0	3.4	3.2	3.8	4.1	3.7	1.9	2.6	3.5
GROSS PRIVATE INVESTMENT	14.9	-11.8	-18.7	20.6	8.2	-6.9	-5.1	7.2	19.0	17.9	16.1	-13.7	0.3	6.9
FIXED INVESTMENT	-7.6	-8.7	-5.8	1.0	-3.4	-5.1	-2.5	6.9	12.6	10.9	11.2	-5.6	-3.9	4.6
NONRESIDENTIAL	-11.8	-10.2	-8.1	-5.0	-4.5	-7.1	-2.3	-0.3	6.6	8.0	11.6	-4.1	-6.7	1.1
STRUCTURES	1.5	-9.1	-8.6	-9.5	-9.3	-13.4	-4.1	0.8	6.2	4.5	7.5	2.2	-8.7	-0.9
EQUIPMENT	-17.3	-10.7	-7.8	-2.8	-2.1	-4.1	-1.5	-0.8	6.7	9.5	13.4	-6.7	-5.7	2.1
RESIDENTIAL STRUCTURES	12.9	-3.4	3.7	27.7	0.4	2.4	-3.4	35.6	34.3	20.3	10.2	-11.6	7.6	17.2
NONFARM	11.6	-2.6	3.5	28.2	-0.1	2.1	-4.1	37.0	36.8	21.5	10.5	-12.7	7.5	17.9
EXPORTS	7.3	-1.4	-1.6	-0.4	3.4	4.4	5.6	5.7	5.2	4.6	4.2	-3.9	1.4	5.0
IMPORTS	14.7	1.6	1.6	3.6	5.8	6.8	5.0	5.9	6.1	8.6	7.7	1.4	4.5	6.3
GOVERNMENT PURCHASES	-5.3	2.5	2.2	2.9	2.2	2.7	2.4	2.7	2.9	1.8	1.1	0.2	2.0	2.4
FEDERAL	-13.6	5.6	5.7	6.4	5.5	6.4	5.3	5.8	6.8	4.1	3.0	1.9	4.6	5.6
STATE AND LOCAL	0.2	0.6	0.1	0.7	0.1	0.2	0.5	0.6	0.2	0.1	-0.2	-0.9	0.4	0.3
TABLE 4.2 - IMPLICIT PRICE DEFLATORS FOR GNP (PERCENT CHANGE, ANNUAL RATES)														
GROSS NATIONAL PRODUCT	4.6	7.4	5.7	6.4	6.0	5.7	6.0	5.0	5.2	5.1	6.1	6.4	6.1	5.5
CONSUMPTION EXPENDITURES	3.6	7.8	5.3	5.6	5.9	5.8	5.4	4.7	4.8	4.5	5.2	6.0	5.8	5.1
DURABLE GOODS	2.3	4.6	2.6	5.2	4.5	5.6	2.2	5.0	5.3	4.2	2.2	4.5	4.2	4.3
NONDURABLE GOODS	0.6	7.4	4.4	4.8	5.9	6.4	5.7	4.7	5.0	5.3	5.8	3.3	5.2	5.4
SERVICES	6.3	8.7	7.1	5.9	5.6	4.7	5.8	4.8	4.9	4.2	5.6	8.5	6.3	5.0
FIXED INVESTMENT	5.7	5.8	6.0	4.3	5.5	5.8	4.1	5.9	6.2	7.3	5.8	4.9	5.3	5.8
NONRESIDENTIAL	7.3	5.9	5.7	3.6	5.1	5.3	5.4	5.8	6.2	6.0	5.6	5.7	5.1	5.7
STRUCTURES	4.8	2.9	4.9	4.3	6.6	6.3	4.5	5.5	7.0	7.8	7.0	6.9	5.0	6.1
EQUIPMENT	6.1	7.6	6.4	4.1	5.2	6.1	6.3	5.7	5.8	5.4	5.5	3.7	5.7	5.8
RESIDENTIAL	-3.1	4.6	5.8	3.9	6.5	6.6	0.5	3.8	4.4	10.2	6.3	3.1	4.5	4.7
NONFARM	-3.6	4.7	5.9	3.6	6.7	6.7	0.7	3.4	4.1	10.1	6.3	3.1	4.5	4.6
FARM	-2.9	4.6	5.8	3.9	6.5	6.6	0.5	3.8	4.4	10.2	6.3	4.0	4.5	4.7
EXPORTS	-0.8	4.6	4.0	4.6	5.7	5.6	5.4	5.3	5.3	5.3	5.3	3.0	4.5	5.4
IMPORTS	-10.2	2.3	4.2	4.8	4.8	3.7	3.8	4.1	4.6	4.5	4.2	-3.9	3.2	4.2
GOVERNMENT PURCHASES	6.2	6.5	8.7	5.1	5.8	5.2	8.5	4.8	5.1	5.0	8.4	7.4	6.4	5.9
FEDERAL	6.2	6.5	14.2	4.2	4.8	3.7	12.3	3.6	3.9	3.7	11.4	8.3	7.0	5.8
STATE AND LOCAL	6.4	6.3	5.2	5.7	6.4	6.2	5.8	5.7	6.0	5.9	6.2	6.8	5.9	5.9
GOVT OUTPUT ORIG	5.8	6.9	9.3	4.1	4.4	4.2	10.9	3.9	3.9	3.9	9.7	8.2	6.0	5.6

Representative REUSS. Thank you very much, Mr. Evans. Mr. Ratajczak.

STATEMENT OF DONALD RATAJCZAK, DIRECTOR, ECONOMIC FORECASTING PROJECT, GEORGIA STATE UNIVERSITY, ATLANTA

Mr. RATAJCZAK. Thank you, Mr. Chairman.

Before going into my statement, I would like to just make some quick observations about the GNP release.

I think it is a little bit unfortunate that we do not have real performance by sector of the economy, because I've been forced to go through here to figure out what the nonfarm economy has done. The evidence appears to be, since the Commodity Credit Corporation was responsible largely for a $7.7 billion reduction in the second quarter and a $2.3 billion increase in the third quarter, and since there was a shift in farm inventories from a negative to an unchanged posture, that basically the nonfarm economy in real terms declined in the third quarter, and there is absolutely no way that anyone can call that an economic recovery. And if they want to call it an economic recovery because the farmers are getting $1.97 for corn and not getting appropriate numbers for wheat, then that's fine—say it in Nebraska. But basically the economy simply has not shown any of the fundamental conditions of economic recovery at the present time.

By the way, I agree with the observation as well in the nonfarm economy that basically any improvement there—and as it turns out it does appear that the nonfarm economy declined—that in the nonfarm economy we have had unbalanced development in the sense that we have had an addition of unwanted inventories, and under those circumstances clearly we would have to expect a continuation of economic weakness through the next quarter, or certainly through the next month. I think we are already seeing evidence of that in the form of very high initial unemployment claims.

Indeed, my forecast for GNP for the fourth quarter is at most a 1 percent gain, and given my analysis of the nonfarm activity, I probably will drop that to a negative GNP performance for the fourth quarter. Therefore, there is no economic recovery at this stage.

What I would like to do before getting to some of the specific issues that have been addressed is first of all talk about those two appendages that were on my prepared statement which has to do with the inflation rate, because there is considerable discussion about what is happening to inflation at the present time.

Of those two releases, No. 1 talks about producers' price changes by stage of processing, and they give us a lot of detail as well as an extended forecast for the next year. That particular release shows that after the decline of one-tenth of 1 percent that was announced recently for September we'll have an increase of four-tenths of 1 percent for October.

Now I view that as actually a very modest performance. And the reason why we are going to have an acceleration in October is fundamentally because the decline in September was as the result of technical conditions related to the end of model year dealer incentives and is not really a measure of the underlying fundamental inflationary forces in the industrial economy.

We do feel that there has been significant progress in industrial inflation. Our estimates of underlying industrial inflation for this year are the lowest since 1972. There is no question that we have made significant inroads.

Furthermore, we do anticipate next year that industrial inflation will be in the 4.5 percent range. The consumer price index we are anticipating for the month of October will actually show no increase whatsoever. The reason for that: Significant declines in mortgage interest rates, both government-supported mortgage interest rates and the conventional mortgage rates, which in the appropriate reference period declined by three-quarters of a percent.

There has been some improvement in inflation. However, I must raise the same issues that were raised by Professor Bator, and that is basically that the cost has been very high. The accomplishments are there, but the cost may very well be excessive.

In addition, the decline of commodity inflation more rapidly than the decline of interest rates has in fact increased economic stress in the system, and that indeed raises interesting questions.

There have been some people naturally assuming that if you can get a decline in inflation rates that you necessarily will see a concomitant decline in interest rates. Clearly this has not been the case, and indeed early this year, in the second quarter of this year, we had some of the highest real rates of interest that have existed since the Depression, and unquestionably this has been a contributing factor to the liquidity problems that have also been discussed today.

I really think that the fundamental problem is one of the high real rates of interest.

I don't share the viewpoint that the economy is about to collapse, although obviously when you are dealing with unemployment rates—10.1 percent this month, probably in the 10.3, 10.4 range next month, certainly 11 percent cannot be ruled out by end of year or early next year—that basically the economy simply is not performing very well.

I think one of the items I would like to point out, because I think I can give a slightly different perspective here, is first of all, why didn't the tax cut do anything? According to our analysis the tax cut did something. And in fact it did it about the time economic theory normally would have anticipated that it would do it basically when the fundamental tax liabilities for dollar earned were changed. And although we know withholding was changed July 1, the fundamental tax liabilities were changed in the calendar year. And indeed, if you take a look at the ratio of consumption to GNP, real consumption to GNP, you find in the first quarter of 1982 that ratio showed its second largest increase since 1950. The only period where it showed a larger increase was the first quarter of 1975. Coincidentally, a tax rebate was very much discussed and then came forward at that period of time.

So in point of fact the reason why the tax reduction has not yet worked is it already has worked. Why hasn't it been more successful? That's the right question. And the answer to that is fundamentally that tax reductions are nice if you have a job, and if you don't have a job, if employment is falling, then the gain from tax reductions is totally wiped out from the losses of reduced incomes.

Let me say a little word here about some economic theories that are going around. First of all, one that I call the monetary expectationists, because I can make some comments on that. Basically this is that if you can get a credible Federal Reserve performance, what will happen is that prices will magically respond to this reduced inflation expectation.

I am not arguing against inflationary expectations. What I am arguing against is that inflationary expectations can be fully reflected in inflation in any reasonable period of time. What that means is that if you knock down inflationary expectations, let's say even one for one, by the slowing of monetary policy, you do not knock down inflation one for one. Then where does the fallout go? Obviously you do knock down expenditures; you're not knocking down inflation as rapidly, so it must go into some form of real economic activity.

There is no painless way of extracting inflation from the economic system. It can't be done in a painless way. It can be done in a less costly way than the current way that we have been pursuing.

The next issue: Why did the real rates of interest stay so high? I think if you take a look at interest rate movements you can get an idea. Clearly the Federal Reserve was a factor, but not the total factor. In June of last year short term interest rates were 14.6 percent; in October they were 13.9. Yet over that period of time long term interest rates increased 2 percentage points. What that says is that something fundamental was being expressed in the savings-investment relationship in the overall economy, and what was happening, of course, was that was the period of time where we passed tax changes that were not fully compensated by expenditures changes and therefore created a secular deficit in the underlying budget. And that is really what has thrown the long term interest rates out of kilter; that is one of the major reasons why real rates of interest have stayed so high so long, and therefore why the recession has remained so much intact.

One other issue, and then I'll get off of this and get back to your questions raised, is basically there is also a feeling afoot that because of the role of expectations that we no longer can control the business cycle. I think there probably is a little bit of truth to the fact that the relationships are not as stable as we would like to pretend that they are, and as a result fine tuning really is something that cannot easily be done.

Nevertheless, I think the evidence does show that we can influence the business cycle. We can make some differences in its performance. Moreover, there is no reason to assume that even if we cannot control the business cycle that we can in fact ignore it, that we can continue to pass multiyear tax reductions, multiyear expenditures programs without regard for its impact upon the underlying dynamics of the economic system. Sooner or later those multiyear programs are going to come into conflict with the basic dynamics of economic development. Unfortunately, this time around they came sooner.

I think now I will go to address your basic points. There are a few other comments I want to make, but they are fairly well covered in my prepared statement

Basically, when will the economic upturn become apparent? Well, as of this testimony my feeling was the first quarter. Given what appears to be deterioration in the nonfarm economy, I may have to scale down my presumptions of economic recovery early in the year.

I still believe that we will have a reasonable recovery, fairly vigorous about midyear and moving through the end of the year. The reason for that fundamentally being that inflation rates have been knocked down. Once we finally get to inventory balance and therefore get to employment balance the improved real purchasing power will start to increase consumer activity. However, that will basically put a floor upon the interest rates. I don't believe that interest rates can continue to move downward in a consumer-led economic recovery under the kinds of deficits that currently persist.

I do think that the declines in interest rates will stimulate some housing activity. We also will see some increases in automoble activity, although not because of interest rates, but rather after 3 years of basically ignoring what has been happening to the relative prices of automobiles we will now see some reduction in prices of automobiles relative to other commodities, and that, according to our analysis, would start finally to stimulate automobile demand.

When will unemployment get back to 7.4 percent? Our forecasting only goes out through 1984, so I can't answer that question. Clearly it will be some time after that period of time, because we are talking about ending 1984 in the vicinity of 8.5 percent unemployment rates.

I do not think that 1984 probably will show 4 percent real growth. I do think also we will have significant increases in productivity. As the workweek extends, that 4-percent growth will not significantly reemploy the people currently unemployed.

Finally, talking about monetary policy, monetary policy at the present time seems to be appropriate. That is a little bit at odds with some of my other colleagues, but I'm not sure that it's going to go that much at odds, because the question is which Federal Reserve activity are you going to choose, and I am choosing the current Federal Reserve activity, which is, in fact, easing while saying it is not, and that particular Federal Reserve activity I view as being appropriate.

By the way, I would argue that there are ways of determining it. The market system does give us some information on the performance of our policies. Basically, if short-term interest rates continue to fall and to pull long-term interest rates down with them, I think that monetary policy can continue to move in an easing direction. At the point of time that declines in short-term interest rates no longer drag long-term interest rates down with them, then we can start to raise the question as to whether the Federal Reserve has overeased. I think the evidence overwhelmingly at this period of time is that the Federal Reserve has not overeased, has not reinstituted inflationary pressures.

I hope that some of these remarks have been useful. I thank you for inviting me.

[The prepared statement of Mr. Ratajczak follows:]

PREPARED STATEMENT OF DONALD RATAJCZAK

Thank you for inviting me to share my views on economic conditions during this day when we receive our first measure of economic performance for the summer quarter. The Economic Forecasting Project at GSU uses monthly estimates of economic conditions to anticipate these quarterly GNP announcements. No surprises are anticipated in this release. Nevertheless, a detailed forecast at this time should fully incorporate the economic conditions that are just now being revealed to us. For that reason, I should like to defer providing detailed projections with my testimony on the state of economic conditions until the Project has absorbed the implications of the GNP report and has incorporated all the latest information into our forecasting system. At that time, I intend to forward detailed tables of our national forecast to all members of the Congress.

Of course, I am merely reluctant to provide detail without current information. This does not alter my perceptions of developing economic conditions.

The economy finally is beginning to develop the preconditions for economic recovery. Normal recessionary flows tend to generate several forces that ultimately lead to economic recovery. First, recession significantly reduces the demand for basic materials and labor. This reduced demand is transmitted into moderation in wage increases and into price declines. Commodity inflation collapsed in the spring and is now showing no significant strength. As shown in the appended tables on the Producer Price Index, prices of finished goods are expected to increase less than 3.5% this year and rebound only to a 4.5% gain in 1983. Wages continue to show moderation. The hourly earnings index currently stands only 6.0% above previous year levels. This is the lowest year-over-year change since the early months of 1974. Despite the slowing of both wage and commodity inflation, the slump in raw commodity prices has created a gap between the two. As a result, purchasing power earned for each hour worked is beginning to increase. Of course, this is only a precondition for increased consumer activity, as the hours worked also must stabilize before real household incomes begin to expand.

Normally, recessions also reduce credit market pressures. The private demand for funds ultimately recedes more rapidly than the recession induced increase in public borrowings of funds. As a result, interest rates tend to fall. Initially, the reduction in commodity inflation may be more substantial than declining interest rates. Indeed, if commodity inflation falls dramatically relative to wages, as occurred early in 1982, the strain on corporate liquidity may be so severe that private borrowings may increase for a short period of time. Thus, interest rates may rise early in a recession. If the onset of recession immediately spawned the forces leading to economic recovery, then recessions would not be very long.

While a stock market rally may not be a precondition for economic recovery, such a rally normally signals that the preconditions exist. As interest rates decline, the alternatives to equity ownership become less attractive. Moreover, as wage inflation slows, corporate liquidity begins to improve. Although profits may decline for a few more quarters, the unanticipated surge in short-term corporate debt that was generated early in the recession is beginning to be retired. Moreover, reduced interest rates lower the interest expenses paid by business. Indeed, if interest rates fall sharply enough, corporate profits could increase even before revenues begin to expand. Obviously, equity owners are encouraged by reduced interest expenses and aggressively seek equity ownership when those conditions develop.

Currently, corporations have significantly shortened the maturity of their debt as they await favorable bond market conditions. The economic lives of their assets greatly exceed the average age of their debt, although the capital base of American industry also is becoming less durable. Much as banks discover that an unbalancing of the maturities in their assets and liabilities increases the sensitivity of their earnings to changes in interest rates, the unbalanced financing of corporate assets has increased the interest sensitivity of corporate earnings. This, in turn, has increased the interest sensitivity of stock values. The stock market rally is responding to these financial conditions more than to anticipations of economic recovery.

Rising equity values generate some direct economic benefits. A $100 billion increase in the market value of equities held by households will increase consumption by $3 billion in the same year. Equity values held by households have improved by more than $200 billion since the market rally began in August. Thus, prospects of increased consumer activity are improving. Furthermore, rising equity values may lead to increased equity financing. If the market evaluates assets at more than it costs to build or acquire them, entrepreneurs will be encouraged to increase their investment activity. (At the present time, however, the cost of asset acquisition is less significant than the utilization of existing assets in determining investment activity.)

Preconditions for economic recovery now are almost in place. However, economic recovery has not yet begun. In the week of October 2, initial unemployment claims rose to 695,000. These figures suggest that payroll employment is continuing to decline by nearly 200,000 jobs a month. Industrial activity probably will decline in October. Automobile sales for the first ten days of October were disappointing. The important fleet sales that normally occur at this season remain lackluster. Our own measures of retail activity suggest that most of the strength in non-auto sales during September occurred early in the month, during the Labor Day weekend, and were generated by substantial marketing incentives. Retail sales may exhibit little growth in October. Thus, consumer expenditures probably will not grow more rapidly than 2% at annual rates after adjustment for inflation in the important fall quarter.

Increases in housing activity, with the aid of subsidized multi-family units and a modest expansion in single family construction in response to declining mortgage rates, could generate some improvement in construction expenditures during the fall. However, little growth in public construction and declines after adjustment for inflation in private nonresidential activity will prevent construction from contributing significantly to economic gains.

Defense expenditures continue to expand. Shipments should now begin to accelerate in response to the strong growth in defense orders that occurred earlier in the year. However, the only other significant growth area in the federal government is in purchases by the Commodity Credit Corporation.

State and local governments simply do not have the operating surpluses with which to increase their expenditures. State and local payrolls probably will continue declining well into 1983.

Plant and equipment expenditures should continue to fall sharply, as orders currently are lagging shipments by more than $2.4 billion per month. Although declining interest rates and an improving stock market normally would generate increased capital expenditures, the low utilization of prevailing equipment forestalls any significant response to improving financing arrangements. Capital expenditures are very sensitive to tax and interest rate considerations when utilization rates exceed 77%, according to our investment relationships. In the range between 73% and 77%, both the cost of capital and the utilization of capital become significant factors. Below 73%, utilization becomes paramount. At the current 69% utilization of available equipment, dramatic reductions in interest rates must be forthcoming before orders for capital goods begin to expand. Shipments normally lag orders by nearly two quarters. (Of course, any aggregate utilization measures remain valid only so long as the composition of activity remains nearly unchanged. Earlier this year, when utilization rates were below 50% for most nonferrous metals, ferrous metals, and automobiles, spending on capital equipment was stronger than our relationships normally would suggest because of continuing expansion in oil exploration. That particular sector now has entered the same capital spending bust that prevails in most other economic sectors. Thus, capital expenditures may grow more slowly than our aggregate relationships suggest in the next few quarters).

The most difficult sectors of the economy to analyze on a short-term basis are inventory investments and net exports. During the second quarter, strong earnings from investments abroad offset continuing modest deterioration in merchandise trade balances. In the third quarter, an unusually strong dollar has further reduced the competitiveness of American goods abroad. Merchandise trade deficits are now rising sharply. Reductions in interest rates worldwide suggest that factor incomes from abroad no longer will be able to offset the adverse impact upon exports generated by a strong dollar. As a result, net exports should contribute to economic weakness through much of 1983.

Changes in desired inventory holdings have caused three attempts at economic recovery during this year. In February, production momentarily accelerated to offset winter induced production disruptions in January. Inventories again stabilized in May, as manufacturers and retailers reached stock levels that were justified by prevailing orders. Unfortunately, some of those prevailing orders were the increased inventory holdings of wholesalers. When interest rates remained high, wholesalers reduced those inventories by cancelling orders. In July, retailers expected the change in withholding rates to significantly improve consumer spending. After a weather related flurry of activity early in July, consumer sales once again slumped. Inventories now are again being aggressively reduced. Producers no longer are assuming that activity will expand. This latest round of inventory liquidations should be sufficient to establish a production base from which activity can expand early in 1983.

In summary, the economy still is being buffeted by crosscurrents. During the fall, strength will be in consumer spending, housing, and defense. Weakness continues in nonresidential structures, plant and equipment expenditures, inventory investment, net exports, and state and local expenditures. We currently believe the pluses will outperform the minuses. However, the projection of 3 to 4% real growth in GNP during the fourth quarter that has recently been presented by the Secretary of the Treasury is very unlikely. Real growth is not expected to exceed 1.0% in the fall.

Why has the consumer not responded to the tax reduction? According to our analysis the answer is that the consumer has responded and at about the time that current theories of consumer behavior normally would predict. Although withholding rates were reduced in July, tax liabilities were reduced for all of 1982 under the assumption that tax rates fell by 10% in July. The income earned in January was subject to the same tax code as the income earnerd in October. Households without severe liquidity constraints were able to increase spending in January, anticipating the withholding reduction that was to take place in July. This explains why consumption as a share of GNP showed the second highest quarterly increase of any quarter since the Korean Conflict during the first quarter of 1982. (The only higher response occurred in the first quarter of 1975 when consumers were anticipating a tax rebate.) Consumption as a percentage of GNP after adjustment for inflation currently is at a 35 year high. The share has increase by 2.8% during the latest year. Thus, the objective of increasing savings and investment as a proportion of GNP has not been achieved.

Those still waiting for the consumer to respond to the 1982 tax reduction will be sorely disappointed. On the other hand, the 1983 tax reduction should begin to stimulate consumer activity during the first quarter of that year. If inventory liquidations, indeed, are completed by that time, rising purchasing power also will begin to contribute to consumer expansion. Partially offsetting these positive forces will be a slowing in the growth of interest income by more than $11 billion in 1983. On balance, 1983 will be the year of the consumer, with expenditures growing at a real annual rate of 3.5%.

Inventory investment, housing, and defense also will be significant contributors to economic growth. Expenditures for nonresidential construction, producers' durables, and state and local activity are expected to continue declining in inflation adjusted terms. Net exports should fall sharply through most of 1983. Although final demand may expand less than 2% in 1983, contributions from inventory restocking will lead to GNP growth of 3%.

Increases in inventory restocking will be a less significant contributor in 1984. Consumer activity will not be able to sustain sharp rates of increase relative to GNP in that year. Because interest rates are expected to remain very high, notwithstanding their current downward trend, recovery in the capital equipment area is expected to be modest. Housing should continue to be a strong contributor to economic growth, however, in 1984. As a result, final demand should increase more than 3.5% and GNP should grow 4% in 1984.

The more interesting question is how we got to where we are today rather than where are we going from here. If the monetary authorities wish to slow inflation they must fall short of accomodating expenditures consistent with prevailing inflation. Some monetary expectationists thought that prices rather than real activity would be reduced by any Federal Reserve policy that established credibility. Later these monetary theorists added the proviso that policy also must be stable. At GSU, our analysis of price determination clearly suggests that prevailing prices depend upon much more than expected inflation. If prices decline before costs, profits must fall. Reduced profits restrict the investment and hiring decisions of corporations. Moreover, contractual or international arrangements may prevent costs from responding quickly to a change in the inflationary environment. Because of impediments to complete price adjustment to changing inflationary expectations, less than full accomodation of inflationary expenditures patterns must lead to some reduction in economic activity. Inflation cannot be extracted painlessly from the economic system.

If only monetary policy were changed to wring inflation out of the economy, short-term interest rates would rise sharply, as a scarcity of funds needed to maintain prevailing expenditures patterns would increase short-term loan rates until money was diverted from portfolio uses. Long-term interest rates, on the other hand, would be buffeted by offsetting forces. Some borrowers would increase their long-term debt to escape the higher yields from short-term instruments. However, rising short-term rates would discourage investors while the tightening of monetary policy ought to lower the inflationary premiums sought by lenders. In fact, short-term Treasury bills yielded 14.6% in June 1981 and a slighly smaller 13.9% in October of last year. Long-term interest rates, on the other hand, surged by nearly 2 percentage points, reaching a peak yield in September 1981. As recently as this June long-term rates were within one-half percentage point of that peak despite a virtual collapse of commodity inflation. Measured in terms of purchasing power, long-term interest rates had the highest yields during June 1982 of any time in the post-depression era. Clearly, this dramatic increase in real rates of interest extended the duration of this recession and increased unemployment. Why did real rates of interest stay so high for so long?

The Treasury Department suggests that the volatility of money growth preserved high rates. I have observed no significant change in that volatility in the past few months. Yet, interest rates now are declining sharply. Other economists argue that inflationary expectations had not been broken until recent weeks. That is an especially disturbing argument, for GSU and other forecasters have been projecting a 5 to 6% inflationary climate in the next several years for most of this year. Why should we not be believed until July and then become strongly believed since then?

In a lecture I was honored to give in celebration of Haverford College's sesquicentennial, I observed that King Canute discovered two things about the tides. First he could not control them. Second, he could not ignore them. Most of the economic studies which maintain that economic policies have little ability to alter the business cycle are based upon dimensionless behavior in an institutionless economic world. Most statistical tests of the theory of policy neutrality draw their observations from real world behavior. Not surprisingly, they show that carefully selected policy can influence the business cycle, although fine tuning of the cycle may not be possible. Business cycles cannot be controlled but they can be influenced.

Multi-year expenditures and tax policies not only deny the necessity to engage in cyclical policy intervention, but they also ignore any distortions being created by underlying cyclical forces. A multi-year tax reduction at a time when real rates of interest already were rising sharply was almost certain to generate destabilizing credit market pressures. (The Laffer curve argument that improved tax incentives would lead to increased economic activity that insured only a momentary need to increase borrowing must be relegated to that dimensionless economic neverland.)

Can it always be appropriate to reduce tax disincentives even where the alternative is increased disincentives created from borrowing? If so, we should finance our entire expenditures program through borrowings. Without any taxes we would eliminate all sheltering activity and all subterranean economic behavior, except to the extent that state taxes justified such behavior. Of course, even with currently falling interest rates, interest expenses alone would be increased by more than $80 billion in the next fiscal year under such a financing program. Furthermore, few economic models would indicate that interest rates could remain unchanged under such a drastic financing rule. If total debt financing of government expenditures is so absurd as to be ruled inappropriate out of hand, then their must be an optimal financing rule for government expenditures. It is not reasonable to declare that deficits do not matter and then maintain that fiscal prudence requires a balanced budget amendment. With such confusion over the financing of government, appropriate finance rules will be achieved only by accident.

Let me establish a basis for an optimum financing rule. When real interest rates are falling, an increase in government deficits may be justified without intensifying distortions in the economy. In the experiment proposed by Keynes, real interest rates remained unchanged both before and after governments used deficit financing. If those conditions prevailed in the 1970s, the Keynesian prescription would not have created the degree of economic distortion that in fact it did create. As real interest rates currently are falling moderately (remember, underlying inflation rates are declining nearly as rapidly as market interest rates) the need to rescind the tax reduction in 1983 to reduce the burden of government deficits is less compelling. On the other hand, real rates of interest were increasing sharply before tax enhancements were enacted this year. As that taxing program reduced the credit market distortions created by inappropriate financing, real interest rates responded favorably to that action.

Although the above discussion is about aggregate budget condition, a strong argument can be advanced toward reducing government capital expenditures during a period of rising real rates of interest just as private decisions have been forced to diverge from its optimum expansion paths. The level of defense expenditures and the speed of defense buildup cannot continue to be excluded from economic evaluation. In the last two years, the projected growth of real defense expenditures has increased even as real interest rates, and therefore the economic burdens created by federal government borrowings, also continued to expand. Of course, economics should not be the only factor dictating defense expenditures. However, an increase in the growth rate of real resources diverted to defense even as the burdens of government borrowings are intensifying must be defended in terms of why those purchases are even more compelling now than they were in a less distorting economic environment.

Although the recent decline in real rates of interest makes the issue of a government deficit less compelling, the magnitude of projected deficits, $165 billion in FY 1983 and $150 billion in FY 1984, and the failure of those deficits to significantly decline as economic activity expands strongly suggests that interest rates cannot remain under downward pressure for any significant length of time. That is why I feel that a slowing in the growth of defense spending must be addressed. In place of a move to rescind the third year of the marginal tax rate reductions, some of which have incentives toward increased savings and work effort, I feel a more productive approach to revenue enhancement is the reconsideration of excise tax increases. Some means of reducing consumption expenditures while reducing interest rate pressures through deficit reduction is especially compelling because of the high concentration of economic activity currently in consumer spending. (If consumption is further adjusted to separate consumer investments in furniture, automobiles and other durables from actual consumption of the services provided by those durables, the exhaustion of nondurable goods and service expenditures, the ratio of this adjusted consumption to adjusted GNP would be even more distorted.) Can there ever be an economically more desirable time to raise gasoline excise taxes than now? The pricing and production of natural gas currently is so confused that the immediate price decontrol subject to a windfall profits tax would soon rationalize production in that industry, raise natural gas prices less dramatically than the currently evolving process of decontrol, and significantly add to government revenues.

I would now like to conclude by specifically responding to the questions posed.

A significant upturn in the economy will not be apparent until the first half of 1983. Economic activity should grow about 4½% in the first half of the year before slowing to a 3½% growth path in the second half. Interest rates should again begin rising soon after the beginning of the year, especially as consumer spending in anticipation of further reductions in tax liabilities will provide some thrust to economic growth. I currently believe the prime rate will not fall below 11% and may be trending modestly upward during the second half of 1983 if no excise taxes are enacted to reduce projected government deficits. Long-term interest rates probably will plateau during the first half of 1983 near current levels. A dramatic increase in interest rates in 1983 currently appears to be unlikely. However, the interest sensitive portions of the economy clearly will not receive significant stimulus from sharp declines in real rates of interest. Only housing is expected to show any significant response, although gains there may be relatively robust. Our current projections are for housing starts to average 1.3 million in the first half of 1983 and then accelerate to 1.5 million in the second half. Starts are expected to be in the 1.6 million range in 1984. Automobiles are expected to expand to a 9.3 million sales rate in 1983 and a 10 million sales rate in 1984, although moderation of relative prices will be more important in reaching those levels of activity than any significant decline in interest rates.

According to this current outlook, unemployment rates probably will peak slightly in excess of 10.5% with the peak occurring about the end of 1982. Of course, if fourth quarter GNP shows less strength than the 1.0% maximum projected here, unemployment rates could rise further. An 11% unemployment rate is not out of the realm of possibility. We currently project that unemployment rates will remain above 9.5% at the end of 1983 and fall to only 8.5% by the end of 1984. Our forecasting process does not go beyond that period, but a return to 7.4% does not appear to be likely until the latest months of 1985 or beyond.

As mentioned above, I clearly believe that the growth of government spending should continue to slow, with more consideration being given to slowing the build-ups in defense spending than has occurred in the past. Further attempts to reduce the deficit are appropriate because real rates of interest, while declining, remain historically high. I would prefer the use of excise taxes, especially on energy consumption. Of course, the social security issue must be addressed. Given current economic conditions, current benefit formulas, and current tax provisions, the next Congress will face a negative cash position in the social security funds.

Monetary policy probably has been too restrictive in the past, when short-term interest rates remained significantly above long-term interest rates long after recession began. Now that the yield curve has begun to show more normal upward sloping characteristics, monetary policy no longer can be significantly criticized. While inflation has been substantially restrained, the Federal Reserve should not end its objective of gradually squeezing all inflationary forces from the economy. A return to controlling interest rates is not appropriate, but I believe that consideration about the structure of interest rates may provide healthier monetary guidelines than a pure money growth formula can achieve. For example, declining short-term interest rates while long-term rates are rising may indicate that monetary policy is too restrictive (or it may reflect excessive deficit financing). Monetary policy currently appears to be appropriate for the prevailing conditions in an economy still suffering from some inflationary pressures.

I hope these comments will stimulate some thoughts concerning policy objectives that prudently can be pursued to improve the health of the nation's economy. As my Project has done extensive work in analyzing inflationary conditions, I have taken the liberty to append the latest information we can generate on consumer and producer price movements. I hope this information will help your deliberations. Thank you.

CPI DETAIL

	Aug. (Est.)	Aug. (Actual)	12 mos. to Aug.	Sept. (Est.)	Oct. (Proj.)
Total Index S.A.	0.6	0.3	----	0.2	0.0
Not Seasonally Adjusted Index	0.4	0.2	5.9	0.2	-0.2
Food & Beverages	0.2	-0.3	3.6	-0.1	0.1
(Food at Home)	(-0.0)	(-0.7)	(2.9)	(-0.4)	(-0.1)
Cereals	-0.1	0.2	4.5	0.2	0.0
Meats	-0.3	-1.2	3.8	-0.2	-0.0
Dairy	0.2	0.0	1.5	0.3	0.1
Fruits & Vegetables	-0.3	-2.8	1.9	-2.8	-1.0
Sugar	1.5	0.2	2.4	0.9	0.2
Fats & Oils	-0.2	-0.4	-4.0	-0.4	-0.2
Nonalcoholic Beverages	0.3	0.2	2.6	0.0	0.1
Other	0.0	0.7	4.7	0.3	0.3
(Food Away From Home)	(0.4)	(0.4)	(5.1)	(0.3)	(0.4)
(Alcoholic)	(0.2)	(0.4)	(4.3)	(0.4)	(0.3)
Other Commodities	0.3	0.1	4.1	0.2	0.4
Apparel	0.3	1.2	1.6	1.7	0.7
Energy (commodities)	-0.7	-0.4	-3.0	-0.2	-0.5
Tobacco	0.5	0.4	9.2	1.2	1.7
Medical	0.5	0.3	9.9	0.6	0.8
Furnishings	0.1	-0.7	3.8	0.2	0.1
Home (purchase)	0.9	0.1	5.6	0.6	0.8
New Cars	0.0	0.1	3.5	-1.9	0.9
Used Cars	1.0	0.7	14.1	0.1	0.2
Entertainment	0.4	-0.2	6.2	0.2	0.2
Services	0.5	0.6	8.6	0.2	-0.9
Rent	0.8	0.5	7.5	0.7	0.7
Mortgage Interest	0.4	0.5	10.1	-1.4	-4.7
Energy	0.4	0.6	12.1	1.0	0.1
Other Household	0.3	0.6	5.1	0.4	0.3
Transportation	0.8	0.2	8.0	0.2	0.2
Medical	1.0	1.0	11.6	0.9	1.1
Other	0.5	0.7	8.6	2.4	0.3
Index Less Home and Mortgage	0.3	0.2	5.6	0.3	0.2
Index on Rental Equivalent	0.4	0.2	5.9	0.4	0.3

*Est. = Estimated
Proj. = Projected

EXTENDED CPI PROJECTIONS
(NOT SEASONALLY ADJUSTED)

Cumulative Changes (Not Annual Rates)	Dec. 1980- Oct. 1981	Dec. 1981- Oct. 1982	Dec. 1980- Dec. 1981	Dec. 1981- Dec. 1982	Dec. 19 Dec. 19
Index of All Items	8.3	4.0	8.9	4.5	5.5
Food & Beverages	4.2	3.5	4.3	4.4	5.6
(Food at Home)	(3.1)	(2.8)	(3.0)	(3.9)	(5.7)
Cereals	6.4	2.8	7.4	3.2	4.5
Meats	0.3	4.4	-0.8	6.1	6.3
Dairy	2.8	1.2	3.2	2.0	4.4
Fruits & Vegetables	7.7	1.6	8.1	2.2	5.6
Sugar	-6.8	4.1	-7.0	4.6	6.5
Fats & Oils	6.6	-1.7	3.7	-2.3	5.3
Nonalcoholic Beverage	2.4	2.8	1.8	4.3	6.5
Other	7.5	3.3	8.4	4.2	5.9
(Food Away From Home)	(6.7)	(4.4)	(7.2)	(5.2)	(5.6)
(Alcoholic)	(5.1)	(4.4)	(5.8)	(5.1)	(5.3)
Other Commodities	6.5	3.5	6.8	4.2	5.8
Apparel	3.5	2.5	2.7	2.0	2.6
Energy (commodities)	10.7	-3.2	10.6	-2.8	5.3
Tobacco	6.9	8.8	7.6	9.1	7.6
Medical	9.7	8.2	11.3	9.7	9.3
Furnishings	5.8	2.5	6.1	2.9	4.1
Home (purchase)	2.0	7.8	1.2	8.9	8.2
New Cars	4.3	-0.1	6.8	1.9	5.3
Used Cars	18.7	8.3	20.3	9.3	6.6
Entertainment	6.3	4.7	7.1	5.3	5.0
Services	11.9	4.6	13.0	4.7	5.1
Rent	7.0	5.8	8.5	7.3	7.5
Mortgage Interest	19.0	-2.0	20.0	-4.6	-3.7
Energy	14.9	13.5	14.7	12.6	10.7
Other Household	9.3	5.0	10.7	5.8	6.8
Transportation	9.9	5.2	11.1	6.1	7.4
Medical	10.7	9.5	12.7	11.3	11.0
Other	8.6	6.8	9.4	7.5	7.0
Index Less Home and Mortgage	7.8	4.2	8.5	5.2	6.4
Index on Rental Equivalent	7.7	4.6	8.5	5.5	6.5

PRICE CHANGES BY STAGE OF PROCESSING

	September (estimated) % Change		September (actual) % Change		% Change 9/81-9/82	Oct. (estimated) % Change	
	NSA	SA	NSA	SA		NSA	SA
Finished Goods	0.1	0.3	-0.4	-0.1	3.6	0.8	0.4
Consumer Finished	0.1	0.3	-0.2	-0.1	3.3	0.6	0.4
Consumer Foods	0.1	-0.4	0.0	-0.5	1.4	-0.6	0.1
Consumer Nonfoods	0.1	0.5	-0.3	0.1	4.0	1.0	0.4
Capital Equipment	-0.2	0.1	-0.7	-0.4	5.4	1.5	0.2
Intermediate Goods	0.5	0.6	-0.1	0.0	0.3	0.1	0.2
Foodstuffs	-0.9	-1.7	-0.9	-1.8	-2.1	-0.7	-0.7
Industrials	0.6	0.8	-0.1	0.1	0.4	0.2	0.2
Crude Materials	-0.8	-0.8	-1.3	-1.5	-3.4	-1.3	-0.7
Crude Foods	-1.8	-2.8	-3.1	-3.8	-4.1	-3.0	-2.2
Other Crude Materials	0.1	0.5	0.7	1.0	-2.4	0.4	0.7

Next Release Date: Thursday, November 18, 1982

ESTIMATED PRICE CHANGES BY SECTOR

	Sept. (est) % Change	Sept. (act) % Change	% Change 9/81-9/82	Oct. (est) % Change
Total Index	0.0	-0.3	1.3	0.1
Food	-0.8	-1.0	-1.1	-1.2
Farm Product	-0.9	-3.1	-6.7	-2.2
Processed Foods	-0.8	0.0	1.9	-0.7
Industrial Commodities	0.3	-0.2	1.8	0.4
Textile	0.3	-0.0	0.4	0.2
Leather	0.2	0.6	1.2	0.4
Fuels	-0.2	-0.6	-0.2	-0.1
Chemicals	0.2	-0.1	-0.6	0.4
Rubber	0.0	-0.1	3.2	0.4
Lumber	1.9	-0.5	-2.2	-0.3
Paper	0.1	0.0	4.1	0.0
Metals	0.8	0.5	-1.0	0.1
Machinery	0.2	0.2	4.6	0.3
Furniture	0.8	0.1	3.3	0.5
Nonmetallic Materials	0.2	0.1	2.4	0.1
Transportation	-1.2	-2.5	5.7	2.3
Miscellaneous	3.1	2.9	5.0	0.6

PERCENTAGE PRICE CHANGES, INDUSTRIAL COMMODITIES, UNADJUSTED

				Index Change	
	Unchanged	Decreased	Increased	Est.	Act.
October 1982	73%	16%	11%	0.4	---
September	78%	10%	12%	0.3	-0.2
August 1982	72	18	10	0.1	0.1
July 1982	76	12	12	0.6	0.7
June 1982	74	16	10	0.4	0.4
May 1982	76	16	8	0.1	-0.1
April 1982	72	15	13	-0.2	-0.4
March 1982	74	16	10	0.1	-0.1
February 1982	65	24	11	0.1	-0.1
January 1982	70	20	10	0.1	0.5
December 1981	71	20	9	0.2	0.3
November 1981	77	19	4	0.1	0.1
October 1981	72	18	10	0.5	0.5

EXTENDED PPI PROJECTIONS
SECTOR PRICES
(Not Seasonally Adjusted)

Cumulative Changes (Not Annual Rates)	Dec. 1980- Sept 1981	Dec. 1981- Sept 1982	Dec. 1979- Dec. 1980	Dec. 1980- Dec. 1981	Dec. 1981- Dec. 1982	Dec. 1982- Dec. 1983
Index of All Commodities	5.4	1.3	12.5	5.3	2.0	5.1
Farm Prices	-4.3	1.6	9.5	-6.2	1.6	4.7
Farm Products	-8.4	-2.0	9.4	-11.6	-3.1	5.8
Processed Foods	-1.9	3.4	9.7	-3.1	4.0	4.1
Industrial Commodities	7.8	1.3	13.2	8.2	2.1	5.2
Textiles	7.1	0.4	10.0	6.8	0.8	3.4
Leather	1.2	1.9	3.1	1.5	2.4	4.3
Fuels	13.4	-0.2	26.2	14.1	0.6	5.0
Chemicals	9.1	0.2	12.6	8.8	0.5	5.3
Rubber & Plastics	6.3	2.5	8.5	6.7	3.1	5.6
Lumber	-5.0	-1.2	3.2	-4.7	1.3	7.4
Pulp & Paper	8.8	2.9	10.8	9.5	3.7	6.3
Metals	5.1	-0.4	6.2	4.4	0.5	5.7
Machinery	7.8	3.3	11.8	8.9	4.2	4.9
Furniture	4.2	2.8	8.5	5.1	3.7	3.5
Non-Metallic Materials	7.6	2.4	12.2	7.7	2.7	5.9
Transportation	9.0	1.6	14.7	10.0	2.7	5.0
Miscellaneous Products	1.2	5.3	16.7	0.9	5.6	4.6

STAGES OF PROCESSING
(Not Seasonally Adjusted)

Cumulative Changes (Not Annual Rates)	Dec. 1980- Sept 1981	Dec. 1981- Sept 1982	Dec. 1979- Dec. 1980	Dec. 1980- Dec. 1981	Dec. 1981- Dec. 1982	Dec. 1982- Dec. 1983
Finished Goods	6.6	2.9	11.8	7.1	3.3	5.4
Consumer Finished Goods	6.3	2.8	11.9	6.5	3.0	5.2
Consumer Foods	1.9	2.2	7.5	1.4	1.5	5.3
Consumer Nonfoods	7.9	3.1	14.2	8.5	3.6	5.2
Capital Equipment	8.2	3.5	11.4	9.2	4.3	6.0
Intermediate Goods	6.0	0.6	12.6	6.0	1.2	4.8
Intermediate Foods	-11.4	0.8	16.1	-12.9	-0.6	7.4
Intermediate Industrials	7.2	0.6	12.4	7.3	1.3	4.6
Crude Materials	-1.1	0.3	12.8	-3.7	0.6	7.7
Crude Foodstuffs	-9.5	1.3	8.6	-14.0	0.2	6.3
Crude Nonfoods	10.5	-0.5	19.1	10.3	1.0	9.2

Representative REUSS. They have, indeed, been useful. Thank you. Finally, Mr. Sinai.

STATEMENT OF ALLEN SINAI, SENIOR VICE PRESIDENT, DATA RESOURCES, INC., LEXINGTON, MASS.

Mr. SINAI. Thank you, Mr. Chairman.

It is nice to be here again. I recall that the last time I was here in January I was quite gloomy. I suspect that my remarks today will be more optimistic than the panel of colleagues, although they are, I would say, cautiously optimistic.

I think the patterns of recession are giving way to patterns that foreshadow an economic expansion. Despite the fact that we really have almost no immediate signs of an imminent end to the long downturns that we have been suffering through, the necessary preconditions for an upturn are emerging, and these are, most importantly, a fundamental turn in the financial markets during this past July, sparked by the dawning realization that inflation rates are permanently down to midsingle digits or below. When I say permanently I mean as far as our forecasting goes, which is for a few years. A tilting away from the original loose fiscal-tight money policy mix of Reaganomics to a tighter fiscal-easier money configuration also is a major factor.

Since midyear short-term interest rates have dropped by 5 to 6 percentage points, bond yields are down about 300 basis points, the stock market has risen by over 30 percent, and the critical process of reliquefication for the financial positions of households, businesses, and financial institutions is really underway.

Borrowing costs for businesses are much reduced, down 4½ to 6 percentage points in the prime and commercial paper rates, and long-term corporate bond yields for top quality debt are down 3 percentage points. The volume of new issues for corporate bonds was around $39 billion, at an annual rate, in the summer quarter, evidence that a restructuring of debt maturities to a longer term is in process.

Mortgage rates are down 3 to 5 percentage points in terms of stated rates, and this reduces the average monthly loan repayment burden by $150 to $200 for the typical 80 percent long-term loan on $60,000 of borrowing.

Consumer loan rates have dropped as well, by 1 to 3 percentage points. That reduces the monthly payments on auto loans by $15 to $25. Not a lot of money, but it is a move in the right direction.

The stock market surge has increased household net worth, by our estimates, $120 billion in real terms, or almost 5 percent. If these patterns in the financial markets are sustained, the pressure on the financial positions in the private sector of our economy should ease up, then flow through to raise spending and housing, consumption, and business capital outlays eventually.

Another important factor is that the Federal Reserve is now acting to sustain this fundamental turn in the financial markets, having relaxed in its slavish pursuit of monetarism, and for good reason. M_1 has really been a poor proxy for nominal GNP, which is the ultimate target of the Federal Reserve, and an imperfect indicator for monetary policy, at least during the past year.

Greater demand for precautionary money balances and increased liquidity preference in a period of exceptional uncertainty has raised M_1 without a corresponding rise in GNP. And the changes in depository instruments makes the measure of transactions balances in the economy very, very difficult.

And so, under these circumstances the central bank has acted prudently and correctly in temporarily departing from its monetary growth targets since following them rigidly would only prolong the recession, as was the case in January and April of this year.

What makes me encouraged, cautiously encouraged at this point in what otherwise is a very grim picture for the economy at this moment of time, is that these patterns of behavior in the financial markets are really very familiar, and they always have preceded economic recovery. And they are not just indicators; they actually have cause and effect impacts on the economy although with variable lags.

Until midyear the patterns of financial market behavior, these patterns that I've described, hadn't yet begun to appear, and that really meant that the economy could not begin to recover without those basic preconditions in the financial markets having existed. But now the patterns have started. We've never had a recovery without most or all of them in place. It has occasionally happened that once the conditions have turned we have not had a recovery, but that really has been quite rare.

The problem is that the lags between when these patterns emerge and a broad-based improvement in economic activity occurs can be quite long. The average length of time elapsed between the turn in the financial markets and recovery for all business-cycle episodes since 1953 is about 9 months. The variance has been 4 to 15 months. In this particular episode the transition from recession to recovery is likely to be painfully slow and probably 2 to perhaps as much as 6 months more before spending responds enough to lower interest rates, the stock markets and the tax cuts to really give us what you would call a significant or meaningful recovery.

The traditional lags are there, which is one reason for these delays. There is another problem special to this episode, and that is the unusually severe fallout of failures and joblessness and deteriorated financial positions from this unprecedented downturn.

I think Mr. Dalio really has described the very negative potential of those possible risks.

The third risk is the possibility of debt deflation, should we have prices actually falling, something Irving Fisher talked about in the thirties. And you really can't dismiss that either. Prices go down so fast, profit margins are squeezed, and a number of businesses can't pay their debts and then banks go under as well. I think basically most of that is behind us now and already has happened.

So in coming months we would expect these financial market patterns to continue, and I'm going to identify them and highlight them as the big part of my remarks because I think these really haven't been touched upon by most of the other panelists.

We would expect further declines of short- and long-term interest rates in this transition.

We would expect continuing moves by the Federal Reserve to support an easier tone in financial markets. This is likely and indeed necessary, and I read Chairman Volcker as saying that monetary policy will now encourage a recovery until one is clearly in view, and that's the next time the Federal Reserve will have to then reassess the policy. But I think they are going to accommodate the recovery until it's actually there and all of us can agree that it's there before they might then think about turning another way.

The third risk, reliquefication by households, businesses, and financial institutions, is in process and will occur over the next year to restore deteriorated balance sheets, and as that happens, then stronger spending patterns will evolve.

This includes reducing debt service ratios as outstanding debt is repaid, and lower interest rates impact on balance sheets.

This includes a sizable reintermediation of funds to depository institutions from the new lower interest rates and new deposit instruments that have now been created.

This includes improvement in affordability parameters for consumers because monthly loan repayments will go down and incomes will rise from the lagged effects of the tax cut.

This includes improving business cash flow relative to expenditures because business will be spending less in the next 6 to 9 months, but their cash flow will jump up because inflation rates are lower and because of the tax cuts of last year.

And the stronger stock market will help businesses to really restructure their debt and to get more equity financing and to lower leverage.

It will also improve sentiment and confidence, eventually more than offsetting the negative effects on consumption from the psychological impact of high joblessness.

And then these bankruptcy problems should, although they remain, fade somewhat in the next 6 to 9 months as well.

So, we are cautiously optimistic on the beginning of a recovery for the economy late in the fourth quarter, with a numerical prediction on real GNP that I would not conclude has really shown a significant recovery, 2 to 2½ percent. Really, the first quarter of a good recovery will be the first quarter of next year. We now think the profile of recovery will take on a traditional cast, with housing activity and increased consumption the leaders, then inventory accumulation and rising employment. Business capital spending will be late, as always, because utilization rates will be low and businesses won't believe the sales are there permanently until they have been there for quite a long time.

Improved affordability of big ticket items from lower interest rates and rising income will help move the economy higher in autos and housing. It really doesn't take much of an improvement in those two categories to get some greater growth.

For 1983 as a whole we are forecasting a 3-percent increase in real GNP. We think the growth rate will be uneven. There will inevitably be another bump up in interest rates because the Fed will have to come to grips in the first half with the monetary aggregates and their relation to policy. But we don't think the blip upward in interest rates will be sufficient to turn and push the economy into another recession or depression in 1983 or 1984.

Now for policy. Policy has really gotten us here and policy has to get us out of the particular problems in the economy. In fairness to policy, it also has, especially monetary policy, given us a magnificent improvement on inflation. The rest of the theory is that interest rates go down, purchasing power rises, and then we get a recovery. And we've got to wait to see that. But that fundamental break in inflation and in inflation expectations, as is now being shown in the financial markets, is not something to take lightly. That is a very fundamental key to eventual recovery and not having a depression.

For policy, the mix of policy and size of the Federal budget deficits will continue, of course, to play a critical role in the prospects for a sustainable recovery. To assure a sustained recovery, both fiscal and monetary policy will have to continue tilting toward a tighter fiscal-easier money mix. This will require further reductions of Federal spending in the fiscal year 1984 budget; that is, the administration should not propose anything less than some very tough budget medicine in January, and in particular, they will have to tackle entitlements and military outlays and the growth in those areas, because that is the only place now for big savings in the budget.

Should they fail to present a budget that really attacks those two areas in a serious way, then the financial markets will send them back to the drawing boards just as they did with President Carter and with President Reagan a year ago.

You know, the financial markets are really neutral; they're bipartisan. No matter what party presents a loose fiscal policy to the financial markets, back to the drawing board the party president will go if it is too loose of a budget.

The Federal Reserve must continue to compensate for any budget tightening by promoting monetary growth somewhat above the upper range of its target limits. Indeed, I think the Federal Reserve will make a fundamental change in policy now that it has realized the folly of slavishly following M_1. It will be good if they look more at those targets in the economy, inflation, and unemployment that they are ultimately shooting at. In fact, I don't even understand why they use M_1, M_2, or M_3, because I think there is enough information content in the economy in the monthly data and real GNP and what we see in inflation and what we know about unemployment to guide policy through those, which are really their ultimate targets. I would wish they would stop using the monetary aggregates and go to those elements in the economy that they really are shooting for.

So this is very critical, and one way or another the Federal Reserve will have to continue to be more accommodating over the next year or two to sustain the kind of recovery that we see in our forecast.

Joblessness—you asked about the unemployment rates. Our current forecast of the peak is 10½ percent. I thought that was a terrible number; it now sounds wildly optimistic here today. We would expect that before the end of the year, and really after that there will be only a cautious pace of rehiring because corporations will be slow to rehire after having been devastated so much in this downturn. We are projecting unemployment rates above 9 percent throughout 1983 and in excess of 8 percent until the end of 1984. Like Mr. Ratajczak, we do not see an end or a 7.4 percent unemployment rate until late 1985.

We do think productivity should show an above average cyclical upturn, and that may be a sleeper in lowering unit labor costs and providing us with very low inflation rates over the next year.

The interest sensitive sectors that you asked about, such as housing, automobiles, and capital formation, should respond favorably to the lower interest rates, although it lags, and improve financial market conditions and rise gradually from the current depressed levels.

However, the rebounds in these areas will be much less and the levels ultimately reach much lower than the previous peaks in 1979 and 1980. We show housing at 1.38 million units in 1983, 1.65 million units in 1984. Those are good increases. That will help the growth rates. But it is far below the level of activity in 1979.

We forecast auto sales of 9 million units by mid-1983 and almost 10 million for the year 1984, but that is far below the 10.6 million unit pace of 1979.

Business capital formation really will not respond until late 1983, and the first good year we see is 1984.

Indeed, 1984 looks to us to be the first basically excellent year for the economy, with broad-based improvement throughout. We really will have rather slow growth until that point.

For the approach of policy, which you also asked about, I've indicated the mixes. Continuing to tilt the mix toward tighter fiscal-easier money is quite critical. I would encourage the Federal Reserve not to worry about the monetary aggregate so much and to permit 6½ percent growth in M_1. That would not be horrible; that will not reignite inflation expectations when there is so much slack now in the economy. It will take us a long time to reignite inflation, which is now fundamentally broken down in much lower levels.

But tilting the mix of policy toward a tigher fiscal and easier money approach alone is no longer sufficient, because we have so much fallout of failures and joblessness. I think now—and this is a change of mind—the tax cut scheduled for 1983 should be permitted to take effect. I had really been opposed to that before, but I believe now we have so much slack in the economy that we really have to have that kind of Keynesian stimulus on July 1, 1983, to keep the expansion going. That makes biting the bullet on Federal Government spending again, in particular entitlements and military spending, very, very essential in helping to keep our expansion going, and, of course, the role of the Federal Reserve as well.

The major task of policy now should turn to insuring expansion without reigniting inflation. This has always been an impossible task. But it is true. We unfortunately now have the opportunity once again to deal with that problem, and I would, I guess, share a view that suggests that it would be better to grow slowly at first if one can grow slowly without causing a stall; it would be better to have a gradual expansion at first, which would then permit the supply-side potential output growth in later years to perhaps keep distance with the increase in aggregate demand.

But I would favor not getting us approaching full employment potential too fast. I think we really have to start looking for new kinds of ways that government, business, and labor can work together to prevent a resurgence of wage costs. It is essential that inflation rates stay low for a sustained recovery. And then we are going to need specific programs to absorb pockets of unemployment that will be left even after the economy recovers.

If you look at the composition of unemployment, it's clear we'll get a reabsorption of the generally well-trained workers. But the economy has been so shaken up by the last 3 years, we are having such a change in where growth is and where growth isn't, such a change in our traditional industrial structure, that we are going to have a lot of lack of reabsorption of workers in heavy industry, and they are not going to work well in high tech. And we're going to have problems with regard to minority groups and with this new structure of the economy in terms of reabsorbing workers.

The Fed will have to come to grips with whether to continue the new Fed policy. That really was appropriate if the goal was to break inflation. It is no longer appropriate; that automatic reaction to the monetary aggregates is no longer appropriate since inflation is no longer public enemy No. 1; unemployment is.

I think we are seeing the Fed make that shift now away from the new Fed policy of October 1979. I would regard it in its current form as temporary, but I believe they will make a permanent change and we will not be back in any form whatsoever to this very quick tightening of monetary policy anytime we have a hint or a little bubble of growth in the economy. If we do, then I would be a lot more pessimistic than our numbers now show.

[The prepared statement of Mr. Sinai follows:]

PREPARED STATEMENT OF ALLEN SINAI*

I. Introduction and Summary

The patterns of recession are giving way to patterns that foreshadow an economic expansion. Despite, as yet, few immediate signs of an imminent end to the long downturn of the U.S. economy, the necessary preconditions for an upturn are emerging. Most importantly, a fundamental turn in the financial markets this past July is laying the groundwork for recovery. The catalysts for this turn have been the dawning realization that inflation rates are permanently down to mid-single digits or below and a tilting away from the original "loose fiscal-tight money" policy mix of Reaganomics to a "tighter fiscal-easier money" configuration.

Since midyear, short-term interest rates have dropped from five to six percentage points, bond yields are down about 300 basis points, the stock market has risen by over 30%, and the critical process of reliquefication for the financial positions of households, businesses, and financial institutions is underway. Borrowing costs for business are much reduced, ranging from 4-½ to 6 percentage point declines in the prime and commercial paper rates to near 3 percentage point reductions in long-term corporate bond yields. The volume of new issues for corporate bonds rose to an estimated $39 billion annual rate in the summer quarter, evidence that a restructuring of debt maturities to a longer term is in process. Mortgage rates have dropped from three to five percentage points, reducing average monthly loan repayment burdens by $150 to $200. Consumer loan rates are lower by one to three percentage points, reducing the monthly payments on a typical auto loan by $15 to $25. The stock market surge has increased household net worth by an estimated $120 billion in real terms, or almost 5%. If sustained, these changes should considerably ease the pressure on the financial positions of households, business, and financial institutions, then flow through to raise spending on housing, consumption and business capital outlays.

In addition, the Federal Reserve is now acting to sustain the fundamental turn in the financial markets, relaxing its slavish pursuit of monetarism and for good reason. M1 has been a poor proxy for nominal GNP, the ultimate target of the Federal Reserve, and an imperfect indicator for monetary policy during the past year. A greater demand for precautionary money balances, or increased liquidity preference, in a period of exceptional uncertainty has raised M1 without a corresponding rise in GNP. And, numerous changes in depository instruments have made the measurement of transactions balances in the U.S. economy extremely difficult. Under these circumstances, the central bank has acted prudently in temporarily departing from its monetary growth targets since a rigid pursuit of them could only continue to prolong the recession, as was the case in January and April of this year.

The recent patterns of behavior in the financial markets are quite familiar and always have preceded economic recovery, providing justification for cautious optimism about the future performance of the U.S. economy, especially in 1983 and 1984. Until midyear, these patterns of financial market behavior had not yet begun to appear, casting doubt on the ability of the economy to mount a meaningful recovery despite the personal income tax cuts of July 1. But now the fundamental financial market behavior that is a precondition for expansion has moved into place, aided by the modest easing in Federal Reserve policy. No recovery has ever occurred without most or all of these financial market underpinnings in place. The necessary turn in financial market conditions has sometimes occurred, however, without a corresponding recovery in the economy.

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*Senior Vice President, Data Resources, Inc. The research assistance of Michael Evelyn and Andrew Lin is gratefully acknowledged.

Unfortunately, the lags between the emergence of these patterns and a broad-based improvement in economic activity can be quite long. The average length of time that has elapsed between a turn in the financial markets and recovery for all episodes since 1953 is approximately 9 months, with a variance of 4 to 15 months. In this particular episode, the transition from recession to recovery is likely to be painfully slow, with two and perhaps as much as six more months to go, and still considerable risks that no meaningful or sustained recovery will occur prior to mid-1983. One reason is the traditional lags that occur before spending responds to lower interest rates, an improvement in the stock market, and tax cuts. Another is special to this episode: the unusually severe fallout of failures, joblessness, and deteriorated financial positions from the unprecedented downturn in the U.S. and world economies since 1979. A third risk arises as a side effect from the major success so far against inflation, the process of debt deflation originally described by Irving Fisher, where declining prices squeeze profit margins, reduce the value of asset collateral, and raise the burden of debt enough to create exceptionally high risks of bankruptcies for debtors. Thus, despite the encouraging signs from the financial markets, no immediate recovery is likely to appear. Instead, some further bottoming out, then a gradual upturn is the most probable pattern.

With historical patterns as a guide, what can be expected in coming months? First, further declines of short- and long-term interest rates should occur in the transition from recession to recovery, the result of a depressed economy, low single-digit rates of inflation, and an increased velocity of money because of reliquefication by the private sector. Second, continuing moves by the Federal Reserve to support an easier tone in financial markets are likely and indeed necessary, even though money growth and levels may be at upper target limits or above them. Third, a major reliquefication by households, business, and financial institutions will occur to restore severely deteriorated liquidity and balance sheet positions. Fourth, debt service ratios will be reduced as households and firms pay down outstanding debt and the effects of lower interest rates impact on balance sheets. Fifth, a sizeable reintermediation of funds to depository institutions should result from the new lower plateau of interest rates and the establishment of new deposit instruments that will be more competitive with money market mutual funds. Sixth, affordability parameters for consumers should gradually become more favorable to purchases of durable goods, as monthly auto and mortgage loan repayments drop and incomes rise from the tax cuts. Seventh, business cash flow should improve relative to outlays with corporate treasurers moving quickly to restructure debt maturities to a longer term. The stronger stock market will permit business firms to reduce leverage through more equity financing, leading to stronger balance sheets. Eighth, lower inflation and a stronger stock market will improve sentiment and confidence, eventually more than offsetting the negative effects on consumption from high joblessness. Ninth, the pressures which have given rise to a rising tide of bankruptcies, commercial bank failures, and shakeup of thrifts will gradually subside as debt service burdens become less onerous and the private sector reliquefies. These patterns in the financial markets and rising real income will bring increased housing and consumer spending, a greater pace for retail sales, increased orders, production, and finally rises in employment.

The personal income tax cuts of mid-summer should provide more stimulus to consumption over the next six months, although households will remain cautious because of high joblessness and strong savings incentives. In retrospect, the minimal impact of the tax cuts on consumer spending in July and August should have been no real surprise. Contemporary theories of consumer behavior almost universally suggest lags in spending of at least several months behind changes in real disposable income. In addition, until recently financial market conditions were not conducive to a more rapid pace of spending.

Major incentives to save in the form of high real aftertax returns on saving and disincentives to borrow from high real aftertax costs of mortgage and consumer loans deterred borrowing and spending. Over a 5% decline in the real net worth of households between 1981:2 and 1982:2 also limited the response to the tax cuts, with falling home and stock prices the major causes for the reduction. Rising joblessness slowed the growth of income and the macro risk of potential joblessness restrained household spending. Indeed, these factors still remain to limit and delay the response of consumption to the October 1981 and July 1982 tax reductions, but will gradually be overcome by the easier financial markets.

The prospects for economic recovery thus are now considerably enhanced, with the likely profile of expansion to be of a traditional variety. Rises in housing activity, retail sales, and consumption activity should lead the recovery. Sharp rises in military spending will provide a sizeable stimulus. Then, increased production for sale and inventories will occur, eventually tending to raise employment. The business sector should join the expansion late, as is typically the case, with capital spending not rising much until reliquefication is almost complete, sales steadily rising, and capacity utilization rates much higher.

The question marks now must focus upon 1) the lags between the fundamental turn in the financial markets this summer and timing of its impacts on the economy; 2) whether the feedback effects of failure fallout and joblessness on confidence and spending will more than offset the stimulus of the lower interest rates, stronger stock market and July 1 personal tax cuts; and 3) the choice of policies to sustain expansion without reigniting inflation.

Some specific conclusions are:

- The U.S. economy should begin an upturn yet in the fourth quarter, although anemic, with sustained but uneven growth to come during subsequent quarters. The profile of the recovery now is likely to take on a traditional cast, with increased housing activity and consumption leading the upturn, then inventory accumulation, and rising employment. Business capital spending will not rise until well after the expansion is under way, in response to permanently higher sales, rising utilization rates, and improved corporate financial positions. The greater affordability of big-ticket items from lower interest rates and rising income will help move the economy higher, as will the impacts of the tax cuts on consumption in general.

- Real economic growth is forecast at 2 to 2½% in the fourth quarter, rising to a 3-1/2 or 4% rate of growth early in 1983, then accelerating during the second half of next year with the third stage of the personal income tax cuts. Real economic growth for 1983 is projected at 3%, with the largest rises occurring in residential construction, consumption, and military spending. The economy will grow unevenly, however, accelerating the pace of expansion during the second half of 1983 and in 1984. By then, the expansion should be broad-based, with almost all areas of the U.S. economy participating, and good-sized rises in sales, production, and employment. However, the expansion is expected to be considerably weaker than the typical postwar experience. The slack generated in the economy by the recessions of 1980 and 1981-82 will still leave a large gap between actual and potential GNP in 1984, however.

- The mix of economic policy and size of the federal budget deficits will continue to play a critical role in the prospects for recovery and its sustainability. Indeed, it is the policy errors of the past, embodied in the budget impasse of earlier this year and slavish pursuit of monetarism by the Federal Reserve, that brought the economy to the brink of a major collapse. To assure a sustained recovery, both fiscal and monetary policy will have to continue tilting toward a tighter fiscal-easier money mix. This will require further reductions of federal spending in the FY1984 budget, including entitlements and military outlays.

- The Federal Reserve must continue to compensate for any budget tightening by promoting monetary growth at or somewhat above the upper range of its target limits. A fundamental change in the approach to policy by the Federal Reserve is probably required, given that the monetary aggregates M1 and M2 will continue to give false readings on the economy and inflation in the new deregulated environment and with so many changes in monetary and near-money financial instruments. Indeed, it would probably be better for the central bank to focus directly on its ultimate targets of real economic growth, inflation, and unemployment rather than an intermediate proxy such as M1, M2, or M3. Sufficient monthly data are now available on the performance of the economy, inflation, and unemployment to make unnecessary the focusing of monetary policy exclusively on the monetary aggregates.

- The liklihood that another series of rises of interest rates will occur to abort an economic recovery in 1983 is much diminished now given the permanently lower rates of wage and price inflation in place, new tilt of monetary policy, and reliquefication in process for the private sector. Nevertheless, the New Fed Policy suggests that interest rates will rise again during the first half of 1983, in response to the forecasted expansion. Current DRI forecasts show another 100 to 150 basis point declines in short-term interest rates during the fourth quarter and a 100 basis point reduction of bond yields. A prime rate at 11%, federal funds rate of 8%, and 7% rate on Treasury bills should be the troughs. Subsequently, interest rates are forecast to decline, on average, falling toward a new lower plateau of inflation but not without occasional upward spikes. Record federal budget deficits prop interest rates by about 100 basis points in 1983 and 1984, suggesting that a further tightening of the budget is desirable.

- Joblessness will emerge over the next year as the most troublesome public policy problem, an inevitable fallout from the breaking of the debilitating double-digit inflation of the 1970s with a sustained tight monetary policy. Indeed, the current unemployment rate of 10.1% understates the problem. Adding 1.6 million discouraged workers to the 11.3 million unemployed and including 2.6 million part-time employees who normally work full-time brings the jobless total to 15.5 million persons or 14.1% of the labor force, an awesome figure. This record joblessness for the postwar period is curtailing growth in income and consumption and offsetting the positive impacts from the July 1 tax cuts.

- A peak approaching 10-1/2% for the unemployment rate is likely in coming months, and even higher rates cannot be ruled out if the recovery is very anemic. Once recovery is in place, a cautious pace of rehiring will likely be followed with the unemployment rate remaining well above 9% throughout 1983 and in excess of 8% for 1984. Productivity growth should show an above average cyclical upturn, reflecting the increased output obtained with a smaller work force and the usual efficiency gains for the early stages of recovery.

- Interest-sensitive sectors of the economy such as housing, automobiles, and capital formation should respond favorably to lower interest rates and improved financial market conditions, rising gradually from the current depressed levels. However, still relatively high real and real aftertax interest rates will limit the rebounds in these and related areas. The DRI projections for housing show 1.38 million units in 1983 and 1.65 in 1984, levels below the activity reached during 1979. Auto sales are forecast at 9 million units by mid-1983, up from the current 7.7 million units but far below the 10.6 million unit pace of 1979. Business capital formation will respond only slowly to the more favorable financial conditions despite the tax stimulus of ACRS, given sluggish sales growth, relatively high interest rates, and low rates of capacity utilization. No sharp increase in business capital spending is projected until 1984, when a 7.1% rise is expected in real terms.

- The reliquefication process will be more substantial than in 1975-76, as the private sector adjusts to a new disinflationary environment. The severe downturn, now most easily understood by observing the complete business cycle history since 1979, has resulted in so much slack in the U.S. economy that the odds have risen on a lower profile of inflation and interest rates than previously had appeared possible. In such an environment, spending and the demand for funds must remain weak, with lower rates of inflation reinforcing an increasing amount of slack in the markets for money and credit. With a major reliquefication by the private sector, even the prospective large federal budget deficits for fiscal years 1983 and 1984 might be absorbed without any resurgence of interest rates.

- The mix of economic policy is being tilted toward a more appropriate track for expansion then previously was the case. A further tightening of the budget and easing of monetary policy is essential to a sustained revival of the interest sensitive areas of the economy and for continuing expansion. But, tilting the mix of policy toward a tighter fiscal and easier money alone is no longer sufficient given the downward momentum from the unprecedented, for the postwar period, fallout of failures and joblessness. For this reason and given the enormous slack in the economy, the tax cuts scheduled for 1983 should be permitted to take effect and not be postponed. But "biting the bullet" on federal government spending, in particular entitlements and military spending, is essential. Should the Administration fail to tackle these issues in the FY1984 budget, the financial markets will again react in familiar negative fashion, with large rises of interest rates threatening the recovery.

- The major task of policy now is to insure expansion without reigniting inflation. This involves inducing 1) gradual growth in the economy without causing it to stall; 2) a new collaboration between business, government, and labor to prevent a resurgence of wage costs; and 3) specific programs to absorb pockets of unemployment that will be left even after the economy recovers. The Federal Reserve will have to come to grips with whether to continue the New Fed Policy, now that the back of inflation has been broken. That policy was designed as a major anti-inflation tool, but no longer may be needed in what now is fundamentally a disinflationary environment.

Most likely, by 1984, the major parameters of the economy will be moving in the directions set by the goals for economic performance, without any major reacceleration of inflation. The odds overwhelming favor economic recovery next year and in 1984 within a backdrop of a chronically weak economy, in fits and starts to be sure, but, on average, showing steady improvement.

Success on inflation is for sure. The role of the federal government is being whittled down. But the costs of the inflation improvement, including jobs, the potential for high interest rates because of large deficits, and chronic weakness in certain areas and sectors, will be sizable. The "wild card" is the fallout on wages, inflation, interest rates, saving, and productivity from the deep downturn of 1980-82. If all breaks right, there will be considerable success in the longer run, despite the shaky start in the short run.

II. Patterns of Recession - The Current Situation

Patterns of recession have been place since late 1979. The current business cycle downturn, perhaps best viewed over the full perspective of the last few years, is the most severe since the 1930s. In the U.S., the real growth of the economy has been near zero since early 1979; retail sales, in real terms, have dropped 1.2% per quarter; industrial production has declined by 2.8% per period; business fixed investment, in real terms, a major target for improvement from the Reaganomics polices, has declined by 1.1% per quarter; and employment has only risen 0.5% per period.

Table 1
Recent U.S. Economic Performance
(Percent chg., cpd. annual growth rate from 1979:1 to 1982:3)

Real GNP	0.2
Implicit GNP Deflator	8.2
Retail Sales (1972 dollars)	-1.2
Industrial Production	-2.8
Business Fixed Investment (1972 dollars)	-1.1
Employment (Household Survey)	0.5

The series of downturns since 1979 is unprecedented for the postwar period, probably the modern-day counterpart to a depression. Aftertax corporate profits will be down over 30% in 1982 compared with 1979. Numerous industries and areas of the country are essentially in depression. Corporate bankruptcies and failures of financial institutions are the most numerous since the 1930s. Joblessness is at record levels for the postwar period, with over 15 million persons working less than desired. Not since the 1930s have there been three successive years of recession; in this case, 1980 and 1981-82.

Chart 1
New Car Sales-Total
(Millions of Units, SAAR)

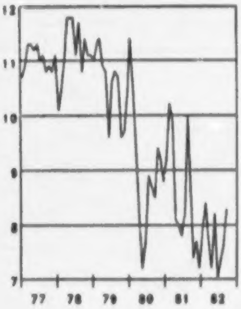


Chart 2
Retail Sales
(Billions of 1972 Dollars, SAAR)

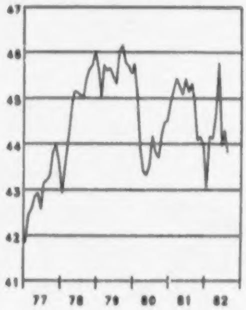


Chart 3
Federal Reserve Industrial Productio
Index - Total (SA, 1967 = 1.0)

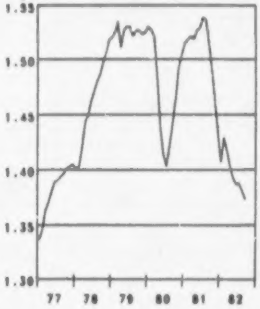


Chart 4
Capacity Utilization - Manufacturing
Total (Percent, SA)

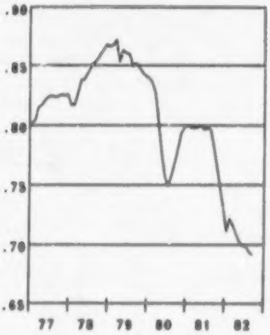
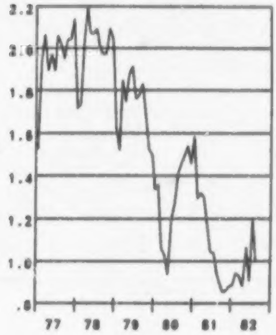


Chart 5
Housing Starts
(Millions of Units, SAAR)



Indeed, not only the U.S., but the rest-of-the-world as well has been suffering through a period of stagnation and rising unemployment as the cure for too high inflation.

Most of the industrialized world has shown little or no economic growth since early 1979, relatively high rates of inflation, and essentially unchanged employment. Real output in the United Kingdom and Canada actually has declined, on average, since the first quarter of 1979. Employment has been falling in the United Kingdom and Germany. Inflation rates have averaged in double-digits for the United Kingdom, Italy, France, and Canada. The best performance has been for Japan, where the growth in real GNP has averaged 3.6% a quarter with a relatively low inflation rate of 5.7% per period. But, by historical comparison, even this performance is deteriorated compared with earlier periods.

Table 2
Economic Performance in the Rest-of-the-World Since 1979
(Percent chg., cpd. annual growth rate from 1979:1 to 1982:3)

	Real GNP	Consumer Price Index	Industrial Production	Employed Persons
United Kingdom	-0.1	13.5	-2.5	-2.8
Germany	0.9	5.6	-0.2	-0.2
Italy	1.3	19.1	0.2	0.7
France	1.6	12.7	0.3	0.3
Japan	3.6	5.7	4.6	2.0
Canada	-0.2	10.9	-2.9	0.7

The U.S. is exhibiting a large tradeoff between unemployment and inflation, in an apparent re-emergence of the Phillips curve. In the U.S., the unemployment rate has risen from 5.9% in late 1979 to a current rate of 10.1% at the same time that inflation rates have declined from 15 to 17%, at annual rates, to the current 4.9% year-to-date for the CPI-U. The United Kingdom, France and Canada have higher unemployment rates now compared with early 1979, and lower inflation rates. But inflation of the Consumer Price Index is now higher in Germany, Italy and Japan, along with the unemployment rate. Thus, the U.S. appears to be exhibiting a relatively greater benefit on inflation from excess slack and stagnation than in most other countries, a major reason for continuing strength of the dollar. However, it is clear that joblessness has emerged now as a worldwide problem, a major fallout of the restrictive monetary policies followed by the U.S. central bank to throttle back inflation in this country.

Table 3
World Economic Performance: 1979:1 to 1982:3

	79:1			80:1			81:1		
	Unemployment Rate (%)	Real GNP (%)	Consumer Price Index (%)	Unemployment Rate (%)	Real GNP (%)	Consumer Price Index (%)	Unemployment Rate (%)	Real GNP (%)	Consumer Price Index (%)
United-Kingdom	5.1	-3.8	12.6	5.2	-0.5	19.6	8.8	1.8	9.2
Germany	4.0	2.3	4.5	3.5	7.5	5.0	4.5	2.2	6.0
Italy	7.5	5.1	16.3	7.7	8.4	27.8	7.6	3.3	22.0
France	5.6	0.5	9.6	6.0	2.0	16.7	6.9	-0.5	13.1
Japan	2.3	5.3	-1.3	2.1	6.7	8.7	2.4	3.0	4.5
Canada	7.8	3.0	9.8	7.5	-1.0	9.5	7.3	5.0	13.8

	82:1			82:2			Latest		
	Unemployment Rate (%)	Real GNP (%)	Consumer Price Index (%)	Unemployment Rate (%)	Real GNP (%)	Consumer Price Index (%)	Unemployment Rate (%)	Real GNP (%)	Consumer Price Index (%)
United Kingdom	11.0	4.4	6.2	11.2	-3.2	9.7	12.7	2.8	8.5
Germany	6.7	-0.9	3.5	7.3	-1.4	4.7	7.8	-0.1	5.9
Italy	9.2	5.9	16.5	9.0	-5.4	12.4	9.6	-4.3	25.2
France	8.2	-0.9	12.4	8.4	2.4	13.0	8.4	3.3	5.7
Japan	2.4	4.0	2.9	2.4	5.1	6.7	2.4	3.7	4.5
Canada	8.6	-8.9	10.6	10.2	-8.0	11.8	12.3	0.6	8.1

It should be noted that the current performance for the U.S. economy and financial markets is the result of sweeping changes in monetary and fiscal policies, new institutional arrangements and regulations, emerging new trends in labor markets, new technology, a changing political structure, and impacts from what now are tightly interrelated international economies. First, the current long and deep downturn is to a large extent the result of an historic attempt by the U.S. central bank to contain a severe, debilitating inflation. The 1970s were characterized by the worst inflation record since early in this century, including wartime periods, with prices, as measured by the Wholesale Price Index, rising 9.4% per annum for the decade. Without action to limit the runaway inflation of the 1970s, the result, both economically and politically, might have been a disaster. The New Fed Policy of October 1979 constituted a major shift in the structure of the U.S. economy, with the potential for uncharted effects since throughout modern American history the role of the central bank had been to stabilize financial markets and to moderate fluctuations of interest rates. The new approach to monetary policy created an unprecedented volatility for interest rates and permitted new, historic high levels that changed the pattern of behavior in the U.S. economy to a more volatile pattern with stagnant real economic growth. The Federal Reserve has been supported by the Administration in its efforts to reduce inflation, unusual for the U.S. where in most instances considerable pressure has been applied to encourage an easing of monetary policy.

Second, massive shifts in federal tax and spending policy have been instituted. Huge reductions in personal taxes were legislated in 1981 for the next five years, with most of the stimulus set to occur from 1983 to 1985. A major shift in spending priorities from nondefense to the military is in process, but with overall growth in federal spending moving lower. The recent tax increases of $98.3 billion legislated in the Tax Equity and Fiscal Responsibility Act of 1982 will only offset about one-fifth of the tax reductions in the original Economic Recovery Tax Act of 1981, thus not disturb the basic new thrust toward lower taxation by the federal government. The tax and spending changes of the Reagan Administration are without precedent in the postwar period, qualitatively and quantitatively different from any other time in modern economic history.

Third, deregulation, enhanced competition, and a changing institutional framework for collective bargaining are impacting on price and wage-setting practices. The airline, trucking, and financial industries all have been deregulated in recent years, helping to lower prices and wages faster and enhancing saving through much higher returns to savers.

Fourth, a new computer technology is revolutionizing decision-making and information processing, both for business and households. New methods of information processing and retrieval, a changing technology for financial transactions, and widespread use of small computers should make possible a leap in productivity growth during the 1980s.

Fifth, more tightly interwoven international economic and financial systems are quickly transmitting impulses from country to country, truly opening the world economy. These changes are the most massive in 50 years, so that the shakup in the U.S. economy and financial markets that has resulted should be no surprise.

The downturns of 1980 and 1981-82 have brought depression to numerous industries and geographical areas of the U.S.. At least 13 industries are operating at the most depressed levels of activity for the postwar period or at capacity utilization rates of less than 50%. Whole sectors of the economy are under extreme pressure, including small business, the thrift industry, and state and local government. The unemployment rate exceeds 10% in 19 states, in contrast with the previous peak month for unemployment, May 1975, when 8 states had double-digit unemployment rates. Much of the Midwest (autos, agriculture, farm equipment, retailers, steel, and trucking), West (building materials, copper, forest products, lead and zinc, mining, real estate and homebuilding, retailers) and South (agriculture, real estate and homebuilding, retailers, small businesses, trucking) are in a state of depression. The financial strain from high interest rates and weak balance sheets has created a "wave of bankruptcies" for American business, which has been suffering from the greatest deterioration in financial position of the postwar era. Falling real net worth for households, principally from declining equity in homes, refinancing difficulties, and record home foreclosure and loan delinquency rates have strained consumers, contributing to a weak spending response to the July 1 personal income tax cuts. And now, the lengthy period of stagnation for so many of the world economies, continuing disinflation, increased joblessness, high interest rates, and low export earnings are threatening the viability of many countries. The debt problems of the LDCs and some advanced countries provide chilling prospects for commercial banks as a result.

Table 4
Unemployment Rates by State
(Percent)

Current Unemployment Rates(1)	
Michigan**	14.5
Alabama*	14.2
West Virginia	13.7
Mississippi*	12.5
Ohio**	12.3
Washington	12.2
Illinois	12.1
South Carolina	11.7
Tennessee	11.6
Kentucky	11.2
Indiana*	11.1
Pennsylvania**	10.9
Louisiana*	10.9
Wisconsin*	10.4
Rhode Island	10.4
Nevada*	10.2
Oregon*	10.1
New Mexico*	10.1
Arizona	10.0

Unemployment Rates in May, 1975	
Arizona	12.4
Rhode Island	12.3
Michigan	12.3
Massachusetts	11.6
Florida	11.4
New Jersey	11.3
Delaware	10.2
Maine	10.2

(1) As of July 1982, otherwise:
*As of August 1982
**As of September 1982

Table 5
"Casualty" List of Sectors, Industries, States, and Countries

Industries

Agriculture
Agriculture Machinery
Air Transport
Autos
Building Materials
Copper
Forest Products
Lead and Zinc
Miscellaneous Metals and Mining
Real Estate and Homebuilding
Retailers
Steel
Trucking

Sectors

Small Business
Mortgage Finance - Thrifts
State and Local Government

States and Latest Unemployment Rate, (%)

	Rate		Rate
Midwest		Mid-Atlantic	
Michigan	14.5	Pennsylvania	10.9
Ohio	12.3		
Illinois	12.1		
Indiana	11.1		
West		South	
Washington	12.2	Alabama	14.2
Wisconsin	10.4	West Virginia	13.7
Nevada	10.2	Mississippi	12.5
Oregon	10.1	South Carolina	11.7
New Mexico	10.1	Tennessee	11.6
Arizona	10.0	Kentucky	11.2
		Louisiana	10.9
Northeast			
Rhode Island	10.4		

Countries

Argentina
Brazil
Chile
Mexico
Peru
Poland
Phillipines
Romania
South Korea
Venezuela

A major beneficial fallout of the most recent business cycle episode has been the breaking of the severe inflation that plagued the U.S. economy during the 1970s. The tight monetary policies of the central bank are almost solely responsible for the improvement. Essentially, the battle against inflation by the Federal Reserve has been waged as a three-stage process. First, the institution of the New Fed Policy permitted interest rates to rise high enough to break the back of a speculative inflation that was rampant throughout the Western World. The sharply higher costs of inventory financing and the attractiveness of high-yielding financial assets broke the speculative fervor in precious metals and basic commodities. Speculation in bonds and stocks also was undercut. The high interest rates strengthened the U.S. dollar and weakened the rest-of-the-world economies, leading to an oil glut and downward pressure on crude oil and energy prices. Speculation in housing and real estate also was subjected to severe pressure, with high financing costs depressing effective prices to squeeze the 1970s bubble of shelter inflation.

The diminuition of inflation from this cause and deep recession in Spring 1980 helped set the stage for exceptional downward pressures on wages, especially in the cyclically sensitive industries such as autos, steel, construction, and trucking. Indeed, the pressure on wages from rising unemployment, givebacks and concessions has constituted the second stage of the battle against inflation, since wage costs are the major cost-side factor in prices. No lasting improvement on inflation could be possible without a major downward turn on wages to limit rises in unit labor costs during the next cyclical upturn.

The final stage for the Federal Reserve in containing inflation permanently most likely will be to permit only a gradual recovery of the economy so that the forces of excess demand will not quickly be unleashed to bring about a sharp reacceleration of inflation. This was the mistake of central bank policy in 1977-1979 when the gains on inflation from the severe recession of 1973-75 could have been propelled forward if monetary policy had not been so accommodative.

Table 6
Sources of Improvement in the Consumer Price Index

	Annual Percent Change		Contribution to Slowdown (Percentage points)
	Dec. 78- Dec. 80	Nov. 81- August 82	
CPI - All Items	12.9	5.1	7.8
Food and Beverages	10.0	3.4	1.2
Energy	27.4	8.8	2.1
Gasoline	35.1	-8.3	2.6
Heating Fuels	37.0	7.9	0.4
Electricity and Gas	15.3	6.9	0.3
Home Ownership	18.1	8.5	2.5
Homes Prices	13.6	6.4	0.7
Finance, Taxes, Insurance	25.4	5.8	2.5
All Other			2.0

Table 7
Wage Negotiation Timetable and Settlements

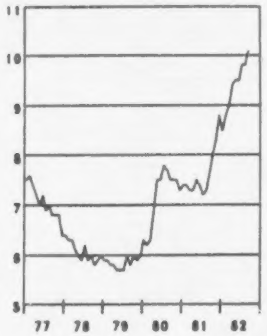
Union	Date	Workers	Results
1981			
Machinists (airlines)	October December	44,800	
1982			
Oil, Chemical, Atomic	January	55,000	Jan. 82: 9% wage increase Jan. 83: 7.1% increase
Teamsters (motor freight transport)	March April November	187,850 55,050 15,000	Mar. 1: No specified wage increase. Lower starting for new employees.
Teamsters (California Food Processors)	June	55,000	
Rubber Workers	April	55,250	7% Wage increase
Ladies Garment Workers	May	220,000	19% Wage and benefit increase over 3 yrs.
	June	66,950	
Electrical Workers	July	150,000	26% Wage and benefit increase over 3 yrs.
Auto Workers (UAW)	September	628,000	Ford-UAW, early agreement
	October	109,000	No specified wage increase Cost of living increases delayed. New employees start at 85% of standard rate
State and Local Governments	All Year	1,900,000	
Building Trades	All Year	750,000	21% Wage and benefit increase over 3 yrs.(although most contracts are for less than 3yrs.)
Food & Commercial Teamsters	All Year	40,000	8-10% Wage and benefit increase over 3 yrs.
1983			
Steelworkers	August	45,000	
Communications Workers (telephone)	August	149,950	

Table 8
Wages, Productivity, and Unit Labor Costs: History and Forecast

	Growth in Compensation Per Hour Index (%CH)	Growth in Productivity (%CH)	Growth in Unit Labor Costs (%CH)
1960	4.3	0.8	3.4
1961	3.2	3.0	0.3
1962	3.9	3.5	0.3
1963	3.5	3.3	0.3
1964	4.5	3.9	0.6
1965	3.4	3.1	0.3
1966	6.0	2.5	3.4
1967	5.5	1.9	3.5
1968	7.5	3.2	4.1
1969	6.6	-0.2	6.8
1970	6.9	0.3	6.7
1971	6.6	3.3	3.1
1972	6.7	3.7	2.9
1973	7.6	2.4	5.1
1974	9.4	-2.5	12.2
1975	9.6	2.0	7.4
1976	8.1	3.2	4.8
1977	7.6	2.3	5.1
1978	8.6	0.6	8.0
1979	9.3	-1.3	10.8
1980	10.3	-0.9	11.2
1981	9.6	1.4	8.1
1982	7.0	-0.2	7.3
1983	6.5	2.0	4.3
1984	7.0	1.8	5.0

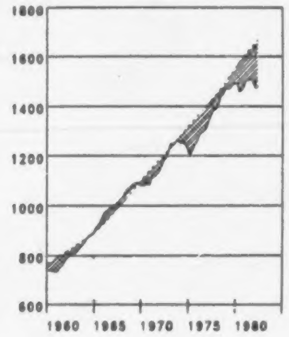
The costs of so much progress against inflation have been great, however. In particular, the fallout includes a record level of joblessness, with the 10.1% unemployment rate the highest in the U.S. since the 14.6% of 1940. The record joblessness is no doubt contributing to the sharp deceleration of inflation, but also is prolonging the recession by holding down the growth of income and consumption spending.

Chart 6
Unemployment Rate
(Percent)



Economy-wide slack exceeds that of any other time in the postwar period, with real output far short of potential, a $196.5 billion shortfall in the third quarter or gap of 11.7%. The All Manufacturing factory utilization rate, at 69.1% during September, is almost at the previous postwar low of 69.0% set in March 1975, and would be lower except that company after company has shut down plants. The primary processing and materials sectors do show the lowest utilization rates of the postwar period.

Chart 7
Real GNP vs. Potential Real GNP
(1960 to 1982:3)



An unprecedented number of business bankruptcies for the postwar period, failures of 25 commercial banks, and a shakeout of thrift institutions has been another fallout of the tough policy against inflation.

Table 9
Business Failures Since 1925

Year	Number of Failures	Failure Rate Per 10,000 Listed Concerns
1925	21,214	100
1926	21,773	101
1927	23,146	106
1928	23,842	109
1929	22,909	104
1930	26,355	122
1931	28,285	133
1932	31,822	154
1933	19,859	100
1934	12,091	61
1935	12,244	62
1936	9,607	48
1937	9,490	46
1938	12,836	61
1939	14,768	70
1940	13,619	63
1941	11,848	55
1942	9,405	45
1943	3,221	16
1944	1,222	7
1945	809	4
1946	1,129	5
1947	3,474	14
1948	5,250	20
1949	9,246	34
1950	9,162	34
1951	8,058	31
1952	7,611	29
1953	8,862	33
1954	11,086	42
1955	10,969	42
1956	12,686	48
1957	13,739	52
1958	14,964	56
1959	14,053	52
1960	15,445	57
1961	17,075	64
1962	15,782	61
1963	14,374	56
1964	13,501	53
1965	13,514	53
1966	13,061	52
1967	12,364	49
1968	9,636	39
1969	9,154	37
1970	10,748	44
1971	10,326	42
1972	9,566	38
1973	9,345	36
1974	9,915	38
1975	11,432	43
1976	9,628	35
1977	7,919	28
1978	6,619	24
1979	7,564	28
1980	11,742	42
1981*	17,040	62
1982**	19,170	86

*Preliminary
**To Date

Source: Dun & Bradstreet

Through September Dun & Bradstreet show a total of 19,170 failures in the U.S. economy, the highest figure since 1932 and certain to produce for this year a volume of bankruptcies seen in the 1920s. Although the failure rate remains well below that of the Great Depression and is a consequence of the long downturn, it is now also a cause of the prolonged recession and failure of the economy to recover. The large number of business failures has created exceptional credit risks for U.S. commercial banks, making lending policies cautious and imposing further restraint. Other businesses are engaged in a major series of cutbacks, designed to preserve viability. The 25 failures of commercial banks that have been recorded are the greatest number in the postwar period. And, dozens of thrift institutions have been forcefully merged or acquired, in a major consolidation of the thrift sector.

Economic weakness has been exported by the U.S. to the international economies through the high and volatile interest rates of the past few years, with similiar problems of slow growth, joblessness, business and bank failures in the rest-of-the-world. Indeed, whole countries now face problems associated with repaying outstanding debt under conditions where export earnings are sharply lower, too weak to cover existing debt service and loan repayment schedules. As a result, the underpinnings of the international financial system are threatened, with potential default and credit risks to the banks throughout the world. The IMF and IBRD have not yet really come to grips with this problem, a major risk to sustainable recovery if sharp rises of interest rates occur again.

Currently, there are few definitive signs of any recovery in the United States and world economies. The recent evidence shows very little change in retail sales and consumption for the third quarter, with the increases of September primarily due to auto sales that may not recur during October. Industrial production continued to slide and inventory-to-sales ratios, in both nominal and real terms, were higher in August. Given that the inventory accumulation was involuntary, business must still decumulate inventories before restoring the lean ratios that are now necessary. Growth in income has slowed from the large increase that occurred early this summer with the tax cuts and increased Social Security payments. The weakness for income is the result of rising joblessness, lower wages and salaries, and a still weak economy, suggesting a limited rebound in consumption spending for yet another month or two. Employment is little changed since June and unemployment is now 11.3 million persons. Consumer sentiment, although rising somewhat lately, remains relatively weak. Finally, after four consecutive months of rises, the Composite Index of Leading Indicators dropped in August by 0.9%.

The recent evidence does contain some hints of a potential recovery, however. Retail sales have risen in 4 out of the past 6 months. Housing starts rose in September and are now 1,146,000, 264,000 units above the 882,000 unit trough in April. Consumer spending, in real terms, rose $7.5 billion during September, more than double the amounts in July and August. The lower inflation for producer prices and almost certain further deceleration in the CPI-U over the next few months augurs well for real purchasing power and subsequent rises in consumer spending. The most apt description for the current state of the economy is a prolonged bottoming-out in transition from recession to recovery.

Table 10
Recent Evidence on the Economy

		1982							1982		
	Latest* (First Domestic Ten Days)	Sep.	Aug.	Jul.	Jun.	May	Apr.	Mar.	III	II	I
Demands:											
Retail Sales - Total (Bils. of $, SA)		89.5	88.6	89.4	88.0	90.8	88.3	87.2	89.2	89.1	86.7
%		1.0	-1.0	1.6	-3.1	2.9	1.2	-0.2	0.1	2.8	0.1
%CH		13.2	-11.2	20.9	-31.3	40.7	15.5	-2.4	0.5	11.5	0.4
%CHYA		1.9	0.7	2.5	0.9	5.2	2.4	1.3	1.7	2.8	1.9
Auto Sales - Total (Mils. of Units, SAAR)	7.4	8.3	7.6	7.3	7.0	8.2	7.2	7.7	7.7	7.5	8.0
%CH	-74.0	179.2	62.1	65.5	-85.0	376.2	-55.3	-64.8	14.7	-24.1	34.2
%CHYA	0.0	-5.9	-24.0	-11.0	-10.3	2.5	-11.1	-22.2	-14.2	-6.3	-19.1
Housing Starts - Total (Mils. of Units, SAAR)			1.002	1.195	0.908	1.066	0.882	0.931		0.952	0.920
%CH			-87.9	2600.1	-85.4	871.5	-47.7	-16.4		14.5	28.0
%CHYA			5.9	14.9	-13.2	-9.0	-32.2	-29.4		-18.8	-34.2
New Orders for Durable Goods (Bils. of $, SAAR)											
%			-4.1	2.5	-1.5	-0.6	-2.1	2.0		-1.2	-1.3
%CH			-39.3	35.2	-16.9	-7.4	-22.8	27.3		-4.8	-5.0
%CHYA			-13.5	-12.7	-14.2	-13.4	-11.8	-7.2		-13.1	-8.0
Personal Consumption Expenditures (Bils. of $, SA)			1987.9	1973.4	1954.7	1954.0	1934.8	1922.4		1947.8	1919.4
%CH			9.2	12.1	0.5	12.5	8.0	-2.6		6.1	7.6
%CHYA			6.0	6.7	6.8	7.7	6.7	6.0		7.1	6.6
Production and Inventories:											
Industrial Production - Total											
%		-0.6	-0.5	0.1	-0.4	-0.7	-1.1	-0.8	-0.9	-1.7	-3.1
%CH		-6.7	-5.9	0.9	-4.2	-8.2	-12.0	-9.6	-3.7	-6.6	-11.7
%CHYA		-9.4	-10.1	-9.8	-9.3	-8.9	-7.7	-6.8	-9.9	-8.6	-6.6
Inventory-to-Sales Ratios - Manufacturing and Trade (*1)											
Nominal			1.520	1.490	1.482	1.462	1.516	1.500		1.497	1.517
%CH			27.7	6.4	17.4	-34.9	13.6	-7.2		-7.8	2.0
%CHYA			5.7	4.9	5.4	3.9	8.2	6.7		5.8	9.2
Real			1.783	1.743	1.739	1.708	1.771	1.752		1.739	1.777
%CH			31.1	3.0	24.3	-35.1	13.4	-6.0		-8.2	-0.2
%CHYA			4.4	3.5	4.1	1.8	6.9	5.9		4.3	7.5
Incomes:											
Personal Disposable Income											
%			0.2	2.0	0.1	0.3	1.0	0.3		1.6	0.7
%CH			2.9	26.9	1.7	3.5	13.1	4.0		6.7	3.0
%CHYA			7.0	7.7	7.3	8.0	8.1	7.5		7.8	8.1
NIA Saving Rate (Percent)				7.1	6.9	6.7	6.8	6.7		6.8	6.7
%CHYA				12.7	9.5	9.8	15.3	17.5		11.5	21.2
Prices:											
FHLBB Sales Price for Existing Single-Family Homes ($1,000, NSA)			69.5	71.1	71.2	69.3	69.1	71.1		69.9	71.3
%CH			-23.9	-1.7	38.3	3.5	-29.0	-23.4		-7.6	3.4
%CHYA			-1.1	-1.8	0.6	9.1	11.1	6.9		6.7	5.4
Consumer Price Index - All Urban Consumers											
%			0.3	0.6	1.0	1.0	0.2	-0.3		1.1	0.8
%CH			3.3	7.3	13.3	12.0	3.0	-3.3		4.6	3.2
%CHYA			5.9	6.5	7.1	6.7	6.6	6.7		6.8	7.6
Producer Price Index - Finished Goods											
%		-0.1	0.6	0.6	1.0	-0.1	0.1	-0.1	1.6	0.2	0.7
%CH		-1.7	7.5	7.1	12.9	-0.9	0.9	-1.7	6.5	0.8	2.9
%CHYA		3.7	4.0	3.7	3.5	3.0	3.3	4.2	3.9	3.3	5.4

Table 10 (Continued)

		1982							1982		
		Sep.	Aug.	Jul.	Jun.	May	Apr.	Mar.	III	II	I
Employment and Utilization:											
Employment - Household Survey (Mils. of Persons, SA)		99.7	99.9	99.7	99.8	100.1	99.3	99.5	99.8	99.7	99.6
%CH		-1.4	1.3	-0.4	-4.1	9.8	-1.8	-1.2	0.1	0.7	-1.9
%CHYA		-0.5	-1.0	-1.1	-0.7	-0.9	-1.5	-0.9	-0.9	-1.0	-0.6
Unemployment Rate (Percent)		10.1	9.8	9.8	9.5	9.5	9.4	9.0	9.9	9.5	8.8
Capacity Utilization - Manufacturing - Total (Percent)		69.1	69.6	69.9	69.9	70.2	70.8	71.6	69.5	70.3	71.5
%CHYA		-11.8	-12.6	-12.4	-12.2	-12.2	-11.3	-10.3	-12.2	-11.9	-10.3
Money And Finance:	Latest*										
Commercial and Industrial Loans at Large Weekly Reporting Commercial Banks (Bils. of $, SA)	222.0	218.8	215.6	214.5	213.6	210.3	206.9	202.4	216.5	210.3	200.3
%CH	18.8	19.5	6.2	5.1	20.6	21.5	30.4	4.8	12.3	21.6	20.3
%CHYA	17.0	16.0	15.4	16.3	18.0	18.0	18.4	17.8	16.0	18.1	15.7
Money (MI) (Bils. of $, SA)	464.9	460.7	455.2	451.3	451.4	451.5	452.4	448.3	455.7	451.8	449.1
%CH	11.5	13.5	10.9	-0.3	-0.3	-2.4	11.5	2.7	3.6	3.3	10.8
%CHYA	7.4	6.8	5.6	5.1	5.4	5.2	4.4	5.6	5.8	5.0	6.5
Three-Month Treasury Bill Rate (Percent)	7.45	7.92	8.68	11.35	12.47	12.09	12.70	12.68	9.32	12.42	12.81
Average Yield on New Issues of High-Grade Corporate Bonds (Percent)	11.09	12.78	13.82	15.66	15.51	14.39	15.54	14.61	14.09	15.15	15.25
Standard & Poor's Stock Price Index - Composite 500		122.43	109.65	109.38	109.70	116.35	116.31	110.84	113.82	114.12	114.21
%CH		275.4	3.0	-3.4	-50.7	0.4	78.3	-32.3	-1.0	-0.3	-23.6
%CHYA		3.5	-15.4	-15.3	-17.1	-11.7	-13.5	-16.8	-9.4	-14.1	-13.2
Sentiment and Expectations:											
Consumer Sentiment Index - U. of Michigan Survey		0.693	0.654	0.654	0.657	0.675	0.655	0.620	0.667	0.662	0.665
%CH		100.4	0.0	-5.3	-27.7	43.5	93.3	-56.9	2.8	-1.6	5.0
%CHYA		-5.2	-15.3	-11.7	-10.1	-11.5	-9.5	-6.8	-10.8	-10.4	-2.6
Vendor Performance - Companies Reporting Slower Deliveries (Percent)		40.0	40.0	37.0	38.0	30.0	31.0	35.0	39.0	33.0	34.2
%CHYA		-7.0	-16.7	-19.6	-20.8	-42.3	-44.6	-32.7	-14.6	-36.5	-30.4
Leading Indicators:											
Leading Indicators Composite Index											
%			-0.9	1.2	0.5	0.9	1.2	-0.1		1.8	-2.0
%CH			-10.5	15.0	5.8	10.9	15.4	-1.0		7.2	-7.8
%CHYA			-4.1	-3.7	-5.1	-6.1	-7.8	-7.9		-6.3	-7.2

(*1) The quarterly inventory-to-sales ratios are averages of the monthly data.

* As of October 6, 1982; Three Month Treasury Bill Rateas of October 15; Corporate Issues Rate as of October 13.

Why is there still no recovery? There are two reasons for the failure of the U.S. economy to recover so far in 1982. First, the budget impasse earlier this year helped sustain a gridlock of high interest rates which pushed the economy lower. In retrospect, the failure to tighten the budget until mid-year and tight monetary policy until that time were egregious policy errors that undoubtedly prevented a recovery from occuring sooner. The high interest rates and deteriorated balance sheets that resulted severely damaged the economic and financial system.

Second, the tax cuts were quite small and not fully reflected in withholding schedules, and were offset by rises in tax receipts from other sources. Federal personal tax receipts fell only $6.2 billion in 1982:3 instead of the expected $25 to $28 billion. Third, the high interest rates, depressed net worth, and increased risks of bankruptcy and joblessness for households limited the response of consumption. In other periods when consumers have responded quickly to tax reductions, e.g., in 1963-65, financial market conditions were more supportive.

What is the impact of the tax cuts so far? The data through September show only modest increases of real consumer spending in July and August. The marginal consumption out of increased real disposable income was only 22.3% in July. By the end of August there was a cumulative rise in this ratio to 55.3%. Then, in September it was over 100%. For the third quarter, the ratio was 57.8%, below the likely 70% to 80% of increased real disposable income that will eventually be spent. The response would have been even smaller had the growth in income more fully reflected the expected reductions in taxes. However, the data for September indicate a $7.5 billion rise in real consumption expenditures compared with the $3.1 billion increases in each of July and August, suggestive of an accelerating response of consumption to the tax reductions. It is safe to say that the full brunt of the July 1 tax cuts has yet to occur, with only a relatively small impact during the third quarter.

This result points up again that a necessary ingredient before a recovery can begin must be a break to lower interest rates. In the 1973-75 downturn, interest rates only broke sharply lower in October 1974. The recovery began six months later. In Spring 1980, interest rates began to drop sharply in April. The expansion began three months later, in July.

Table 11 shows that sharp declines for interest rates have occurred since midyear, with reductions of 5 to 6 percentage points in short-term interest rates and about 3 percentage points for long-term rates. This pattern is familiar as is the surge of stock prices that has followed. With the rate declines not so sharp as in Spring 1980, longer lags can be expected before an upturn. But the reductions are consistent with the qualitative patterns of late 1974, early 1975 and Spring 1980, suggesting that the first essential precondition for expansion is now well in place.

Table 11
Interest Rate Behavior In Spring 1980 and Summer 1982

	Interest Rate Behavior In Spring 1980				Interest Behavior Since Mid-1982			
	4/2/80	5/7/80	6/18/80	Change 4/2/82-6/18/80	7/2/82	8/6/82	10/15/82	Change 7/2/82 - 10/15/82
Short-term:								
3-month Treasury Bills	14.80	9.67	6.49	-8.31	12.52	10.35	7.45	-5.07
Federal Funds	19.39	12.96	8.99	-10.40	14.00	10.63	9.38	-4.52
90-Day CDs	17.97	11.30	8.17	-9.80	15.20	11.65	9.40	-5.80
90-Day Eurodollars	19.60	12.96	8.99	-10.61	15.81	12.63	10.13	-5.68
90-Day Commercial Paper	17.22	11.07	7.97	-9.25	14.50	10.75	8.25	-6.25
Bank's avg. cost of funds	21.80	14.04	9.44	-12.36	15.50	11.90	9.86	-5.64
Prime	20.00	17.50	12.00	-8.00	16.50	15.00	12.00	-4.50
Long-term:								
AA Utility	15.04	12.70	11.71	-3.33	16.37	15.65	13.54	-2.83
10-Yr. U.S. Govt.	12.62	10.08	9.51	-3.11	14.39	13.87	11.15	-3.24
20-Yr. U.S. Govt.	12.43	10.22	9.59	-2.84	13.96	13.46	10.95	-3.01
Bond Buyer Index	9.44	7.11	7.55	-1.89	12.58	11.87	9.25	-3.33
Mortgages:								
New Commitment	16.34	16.23	13.25	-3.09	17.00	16.25	14.50	-2.50

III. Patterns of Recovery and Prospects for the U.S. Economy

The patterns of recovery begin even as a recession is still in progress. The motion of a typical business cycle includes a late response by the business sector in recession after sales and orders have been declining for quite some time. Most typically, declining profits and rising interest rates also lead to a substantial deterioration in the financial positions of corporations, with rising risks of bankruptcy and an overwhelming necessity to restore balance sheet strength and liquidity before a new upturn can begin. Inventories are decumulated, capital outlays cut back, and employment reduced in the business sector downturn, usually about halfway or three-quarters to the end of recession. The restraint on business uses of funds for spending on goods, services, and employment is then felt throughout the rest of the economy, extending and intensifying the downturn that previously began with weakness in other sectors. This late business sector response is the reason why the unemployment rate rises beyond the end of recession for anywhere from one to three months. In addition, the reduced growth in wages and salaries at this stage of the downturn causes sluggish growth of income and a weak pace of spending on consumption goods, which serves to prolong the recession.

Some time during the latter stages of a recession, underpinnings of relief in the financial markets begin to occur. Typically, the central bank sparks declines of interest rates in order to stimulate renewed economic growth or accommodates fiscal stimulus designed to revive the economy. In the early stages of recession, declines of interest rates most typically arise from weak final demands, a diminuition of inflation, and reductions of credit demands. But at some point an easing by the Federal Reserve has always been a necessary ingredient to any incipient recovery, although with lags still occurring before the expansion actually takes hold.

For recovery to occur it is necessary for the familiar patterns in financial markets to occur. What are these patterns? First, short- and long-term interest rates must decline (Table 11). This has occurred.

Second, the Federal Reserve must ease on monetary policy to sustain the lower interest rates, reliquefy the banking system, and encourage the repair of deteriorated balance sheets. This now also has happened with the most recent tilting of monetary policy away from slavish adherence to the monetary aggregates and a more eclectic approach that depends on general economic and financial market conditions.

Third, the stock market must enter the early stages of a bull market, since improved stock prices not only help sentiment and consumer spending but also serve to raise wealth and spending, although with lags. An improved stock market is a boon to corporate finance, opening another source of long-term funding which permits a restructuring of balance sheets and reduces the cost of capital. This process, too, is now in effect, with over a 30% rise in the S&P 500 common stock index since mid-August and an approximate $120 billion increase in the market value of household net worth, in constant dollars.

Fourth, reductions of interest rates affect affordability parameters for households, lowering the monthly mortgage loan and consumer loan repayment burdens as well as reducing the aftertax cost of borrowing. These effects always have been important to consumer purchases of big ticket items, with some of the largest responses in consumer spending on autos and houses occurring once the loan repayment burdens have declined. Price declines for these items also can enhance affordability, along with rising disposable income. In this episode, a combination of all three has begun with the 3 to 5 percentage point reductions in mortgage rates since July and 1 to 3 percentage points drop in consumer loan rates, stability in auto prices, falling prices for real estate, and rising disposable income from the personal tax cuts.

Fifth, the process of reliquefication must be occurring before households resume a rapid pace of spending. The rebuilding of balance sheets, paying off of indebtedness, and accumulation of financial assets is the mirror image in the flow-of-funds of the increased saving that occurs during recession. Each sector must go through this process, although for business a longer period of time is required. In any case, the corporate sector is the last to respond in an upturn, needing sufficient time to reliquefy before additional spending comes about. One problem with the downturn of Spring 1980 is that it did not last long enough to permit a full reliquefication for the various sectors in the economy, so that the appropriate preconditions for a sustained recovery were not established.

Other patterns include much lower inflation rates, rising real incomes, and most typically private sector absorption of large federal budget deficits without a substantial increases of interest rates. All of these processes are in place now. So long as the Federal Reserve remains more accommodative, there is no reason why the patterns of recovery in the financial markets cannot evolve to an economic upturn. Thus, the outlook for the U.S. economy has taken a significant turn for the better.

Table 12
Data Resources Forecast of the U.S. Economy CONTROL102682

	1982		1983				1984		Years				
	III	IV	I	II	III	IV	I	II	1981	1982	1983	1984	1985
GNP and Its Components Billions of Dollars - SAAR													
Total Consumption	1989.5	2026.3	2068.4	2111.7	2161.7	2212.5	2265.6	2323.1	1843.1	1970.7	2138.6	2350.8	2581.4
Nonres. Fixed Investment	341.6	334.6	336.7	341.1	351.2	362.8	375.6	388.7	346.1	346.4	348.0	395.9	453.1
Res. Fixed Investment	97.4	107.3	116.8	124.1	134.1	143.2	150.4	157.9	105.0	98.4	129.5	162.6	193.0
Inventory Investment	-0.5	-6.2	5.1	8.6	11.6	17.4	23.3	24.3	20.4	-14.6	10.7	27.2	34.2
Net Exports	13.2	18.6	21.6	18.6	15.0	17.3	15.2	10.2	26.1	24.5	18.1	13.3	10.9
Federal Purchases	257.5	270.1	272.5	276.2	283.5	293.0	297.9	306.5	228.9	255.4	281.3	311.0	347.8
State and Local Govt. Purchases	392.6	399.1	401.2	408.9	414.3	418.6	425.4	432.2	368.0	389.7	410.7	436.7	476.5
Gross National Product	3091.4	3149.7	3222.2	3289.1	3371.5	3464.7	3553.4	3642.8	2937.7	3070.4	3336.9	3697.5	4096.8
Real GNP (1972 Dollars)	1491.2	1488.8	1501.2	1512.8	1529.3	1546.9	1562.9	1579.7	1502.6	1479.8	1522.5	1585.0	1652.5
Prices and Wages - Annual Rates of Change													
Implicit Price Deflator	5.4	5.6	6.0	5.3	5.7	6.6	6.2	5.8	9.4	6.1	5.6	6.1	6.6
CPI - All Urban Consumers	7.6	2.7	5.6	5.7	5.9	5.9	6.5	6.2	10.3	6.1	5.3	6.1	6.4
Producer Price Index - Finished Goods	6.5	2.6	4.0	4.6	5.6	6.1	7.4	6.9	9.3	3.9	4.3	6.4	7.2
Compensation per Hour	6.4	6.0	7.0	6.4	7.0	6.8	7.7	6.9	9.6	7.1	6.6	7.2	8.0
Core Inflation	7.6	7.2	6.8	6.5	6.2	6.0	5.9	5.9	9.0	7.8	6.4	5.9	6.1
Production and Other Key Measures													
Industrial Production (1967=1.000)	1.381	1.375	1.400	1.423	1.458	1.494	1.522	1.543	1.509	1.392	1.444	1.560	1.647
Annual Rate of Change	-3.7	-1.6	7.6	6.7	10.0	10.2	7.7	5.8	2.6	-7.8	3.7	8.0	5.6
Housing Starts (Mil. Units)	1.114	1.149	1.226	1.328	1.474	1.531	1.573	1.637	1.100	1.034	1.393	1.675	1.837
Retail Unit Car Sales (Mil. Units)	7.7	7.8	8.1	8.4	8.9	9.1	9.5	9.8	8.5	7.8	8.7	9.9	10.4
Unemployment Rate (%)	9.9	10.3	10.2	9.9	9.7	9.4	9.2	8.8	7.6	9.6	9.8	8.6	7.9
Federal Budget Surplus (NIA)	-157.7	-173.3	-153.5	-147.6	-169.4	-160.3	-152.9	-146.0	-60.0	-142.2	-157.7	-144.6	-122.6
Money and Interest Rates													
Money Supply (M-1)	455.7	467.3	471.8	475.0	483.0	494.7	499.0	505.1	436.7	467.3	494.7	519.8	546.0
% Change, 4th-Qtr. to 4th-Qtr.	3.5	10.6	3.9	2.8	6.9	10.1	3.5	5.0	5.0	7.0	5.9	5.1	5.0
New AA Corp. Utility Rate (%)	15.02	12.55	13.10	12.92	12.15	12.37	12.57	11.69	16.25	15.13	12.64	11.59	10.94
New High-Grade Corp. Bond Rate (%)	14.09	11.62	12.17	11.99	11.44	11.75	11.98	11.15	15.01	14.03	11.84	11.07	10.48
Federal Funds Rate (%)	11.01	9.20	10.17	10.22	9.18	9.85	10.06	9.48	16.38	12.24	9.86	9.39	9.91
Prime Rate (%)	14.72	11.72	12.42	12.36	11.59	12.53	12.94	12.15	18.87	14.80	12.23	12.15	12.29
Incomes - Billions of Dollars													
Personal Income	2597.9	2636.8	2689.5	2744.5	2815.4	2889.0	2953.1	3026.3	2415.8	2574.4	2784.6	3067.4	3364.6
Real Disposable Income (%Ch)	2.3	1.7	1.5	2.8	8.3	4.4	3.1	3.5	2.5	1.3	3.0	4.2	3.2
Saving Rate (%)	6.9	6.6	6.3	6.3	7.2	7.3	7.2	7.0	6.4	6.7	6.8	7.1	7.0
Profits Before Tax	174.9	177.9	184.9	193.2	204.1	217.8	229.8	240.1	232.1	174.0	200.0	246.5	282.8
Profits After Tax	118.5	119.8	120.1	125.1	131.8	140.1	147.3	153.8	150.9	117.4	129.3	157.8	177.2
Company Profits	93.6	87.2	93.2	97.7	103.6	110.8	112.2	116.4	107.2	89.8	101.3	119.7	139.9
Four-Qtr. Percent Change	-11.5	-17.2	3.7	10.4	10.7	27.1	20.4	19.2	2.6	-16.3	12.9	19.1	16.9
Composition of Real GNP - Annual Rates of Change													
Gross National Product	0.8	2.1	3.4	3.1	4.5	4.7	4.2	4.4	1.9	-1.5	2.9	4.4	3.9
Final Sales	-0.6	2.9	2.0	2.8	4.2	4.1	3.6	4.3	1.0	-0.6	2.2	4.0	3.9
Total Consumption	1.4	3.1	2.6	3.1	4.0	3.9	3.3	4.4	1.8	1.0	2.9	3.8	3.3
Nonres. Fixed Investment	-13.0	-10.5	-0.8	1.2	6.6	7.7	7.9	8.0	3.5	-4.6	-3.3	7.4	7.3
Equipment	-15.0	-8.3	3.6	5.6	10.0	9.9	10.1	9.8	2.4	-7.3	-1.2	9.6	8.5
Nonres. Construction	-8.6	-14.7	-9.5	-7.8	-0.8	2.6	3.0	3.7	6.3	1.8	-7.7	2.1	4.2
Res. Fixed Investment	4.1	40.5	32.7	19.0	26.3	21.1	12.7	13.3	-4.9	-9.0	24.8	16.7	9.3
Exports	-10.4	-0.9	4.0	4.5	4.0	6.3	6.1	5.7	-0.5	-4.3	1.6	5.5	5.1
Imports	2.7	-5.4	2.8	7.3	7.2	5.0	5.9	11.2	7.2	1.1	3.4	6.6	5.7
Federal Government	19.4	9.1	-1.8	0.0	5.1	1.1	0.6	6.2	3.7	3.7	3.2	2.9	4.2
State and Local Governments	-0.7	0.9	-4.1	1.3	-1.1	-2.2	-0.2	0.0	-0.8	-1.0	-1.0	-0.3	1.9

Table 13
U.S. Economic Prospects: CONTROL102682

	Actual 1980	1981	Estimate 1982	1983	1984	1985	1986
Major economic indicators:							
Gross national product (percent change, fourth quarter over fourth quarter):							
Current dollars	9.4	9.6	4.9	10.0	11.1	10.5	9.4
Constant (1972) dollars	-0.3	0.7	-0.1	3.9	4.6	3.5	2.5
GNP deflator (percent change, fourth quarter over fourth quarter).	9.8	8.6	5.0	5.9	6.2	6.8	6.4
Consumer Price Index (percent change, fourth quarter over fourth quarter) 1/	12.6	9.6	4.5	5.8	6.1	6.6	7.3
Unemployment rate (percent, fourth quarter)	7.5	8.4	10.3	9.4	8.1	7.6	7.4
Annual economic assumptions:							
Gross national product:							
Current dollars:							
Amount	2626	2938	3070	3337	3690	4097	4496
Percent change, year over year	8.8	11.8	4.5	8.7	10.6	10.8	9.7
Constant (1972) dollars:							
Amount	1481	1503	1480	1523	1590	1652	1702
Percent change, year over year	-0.2	1.9	-1.5	2.9	4.4	3.9	3.0
Income:							
Personal income	2160	2416	2574	2785	3067	3365	3712
Wages and salaries	1344	1494	1565	1677	1844	2024	2222
Corporate profits 2/	246	232	174	200	247	283	283
Price level:							
GNP deflator:							
Level (1972=100), annual average	177.4	195.5	207.5	219.1	232.5	247.9	264.1
Percent change, year over year	9.0	9.4	6.1	5.6	6.1	6.6	6.5
Consumer Price Index 1/:							
Level (1967=100), annual average	247.0	272.4	289.1	304.5	323.0	343.8	368.9
Percent change, year over year	13.5	10.3	6.1	5.3	6.1	6.4	7.3
Unemployment rate:							
Total, annual average	7.1	7.6	9.6	9.7	8.6	7.8	7.5
Insured, annual average	3.8	3.5	4.9	4.3	3.7	3.2	2.8
Federal pay raise, October (percent) 3/:							
Civilian	9.1	4.8	7.0	5.0	5.0	5.0	5.0
Military	11.7	14.3	8.9	7.6	5.5	6.0	5.0
Interest rate, 90-day Treasury bills (percent) 4/	11.4	14.0	10.5	9.0	8.8	9.2	11.2
Deficit (NIA, bils. of $'s).	-59.6	-60.0	-142.2	-157.7	-144.6	-122.6	-136.1

1/ CPI for urban wage earners and clerical workers. Two versions of the CPI are now published. The index shown here is that currently used, as required by law, in calculating automatic cost-of-living increases for indexed Federal programs.

2/ Excludes the direct accounting effect of the Administration's depreciation proposal on business income, although all categories of economic assumptions do reflect the economic impact of this proposal.

3/ This indicator measures unemployment under State regular unemployment insurance as a percentage of covered employment under that program. It does not include recipients of extended benefits under that program.

4/ Pay raises become effective in October of each year -- the first month of the fiscal year. Thus, the October 1981 pay raise will set new pay scales that will be in effect during fiscal year 1982.

5/ Average rate on new issues within period. The projections assume that interest rates decline with the rate of inflation and inflationary expectations. These projections do not represent a forecast of interest rates.

Source: Budget of the United States Government, Fiscal Year 1983, Office of Management and Budget, February 1982, pp. 2-5, 2-7, 9-47.

The patterns of recovery are ingrained in the DRI forecast, although with still a residue of restraint on the upturn since a gradual recovery is likely to be a goal of policy. Relatively high nominal and real interest rates, although down substantially from previous peaks, will restrain the recovery in interest sensitive sectors sufficiently to keep the expansion to about half the pace experienced in the typical postwar recovery.

The DRI forecast of the U.S. economy shows a continuing bottoming-out of the recession for another month or two, then meaningful recovery late this year. Real GNP should rise from 2 to 2-1/2% in the fourth quarter, then accelerate to a 3 or 4% pace of growth in early 1983, picking up speed in the second half of next year as the last stage of the personal income tax cuts takes effect. The full impacts of the lower interest rates and improved stock market of this summer should impact toward the end of the year and through most of 1983, provided any upward spike that might occur for interest rates is only moderate and quickly erased. The profile of the recovery is mainly a traditional one, with rises of housing starts and consumption spending leading the way, increased inventories contributing to growth in the first half of 1983, and a strong pace of military spending providing support throughout. Real economic growth is projected at 3% for 1983, although with only a moderate pace of expansion until the second half. 1984 is the first really good year for the economy since 1978, with real GNP up 4.4%.

The Federal Reserve is assumed to accommodate a recovery until it is in place, then tighten up somewhat, bringing rises of interest rates in the first half of 1983. Another round of declines this quarter from 100 to 150 basis points for short-term interest rates and 100 basis points in bond yields insures that a recovery will take place. The prime rate is forecast at 11%, 90-day Treasury bills at 6-1/2 to 7%, and the federal funds rate at 8% before the end of this quarter. Long-term bond yields continue to decline, reflecting the realization of investors that inflation rates are now down into mid-single digits rather than the 8 or 9% previously discounted into bond prices. The large deficits of 1983 and 1984, estimated at from $150 to $161 billion, prop interest rates some 100 basis points higher than would otherwise be the case, but an assumed heavy reliquefication by the private sector helps the deficit to be absorbed without further rises of interest rates. Also, the apparently permanent disinflationary environment is of major help in keeping bond yields lower. The stock market is projected to continue rising, with the Dow Jones surging into the 1100 to 1200 area over the next year.

These financial market patterns serve to promote a mending of deteriorated balance sheets for households and business. The banking sector benefits from the lessening credit risks. The rest-of-the world also is a beneficiary, with lower interest rates abroad possible without major harm to foreign currencies, thus easing pressure on the world economies. With some recovery in basic commodity prices, the export earnings of LDC's move higher. Lower interest rates the world over make the burden of debt service and loan repayments somewhat easier for these countries, lessening the potential for a dire crisis of defaults by foreign counties.

The interest sensitive areas in the U.S. economy, housing, autos, and business capital formation, all show modest rises compared with other periods of recovery. U.S. auto sales, both domestic and imported, rise to 8.8 million units in 1983, a large increase over this year, but far below the 10.6 million units of 1979. Housing starts move over 30% higher in 1983, reaching 1.38 million units, but also remain far below previous peaks such as the 2 million units of 1978. Business capital formation is slow to respond to the improving economy with no real prospects for a revival until the second half of 1983. Indeed, it is not until 1984 that a recovery-like pace occurs for real nonresidential fixed investment. The U.S. trade balance remains negative through the rest of this year and into 1983, before the effects of a weakening dollar cause a reversal. Even then, there is still a slight negative balance on foreign account.

The outlook for interest rates shows a "down," "up," then "down," pattern, with lower interest rates, on average, progressively over the forecast horizon. Interest rates are lower a year from now than currently and also for most of 1984. The reasons are:

Table 14
History and Forecast of Key Interest Rates
(Percent)

	1982				1983				Years				
	I	II	III	IV	I	II	III	IV	1980	1981	1982	1983	1984
Short-Term:													
Federal Funds...........	14.23	14.51	11.01	9.20	10.17	10.22	9.18	9.85	13.36	16.38	12.24	9.86	9.39
3-Month Treasury Bills..	12.81	12.42	9.32	7.53	9.39	9.10	8.50	9.15	11.43	14.03	10.52	9.04	8.80
3 Month Commercial Paper	13.81	13.81	11.15	9.12	11.07	10.49	9.64	10.43	12.66	15.33	11.97	10.41	9.98
3-Month CD's............	14.24	14.24	11.60	9.32	11.30	10.74	9.88	10.74	13.05	15.92	12.35	10.66	10.27
Prime Bank Loans........	16.27	16.50	14.72	11.72	12.42	12.36	11.59	12.53	15.27	18.87	14.80	12.23	12.15
Intermediate-Term:													
3-5 Year U.S. Government Bonds......	14.45	14.10	13.00	10.99	12.07	10.69	9.43	10.09	11.51	14.34	13.13	10.57	9.72
Long-Term:													
AA-Utility..............	16.78	16.17	15.02	12.55	13.10	12.92	12.15	12.37	13.14	16.25	15.13	12.64	11.59
Bond Buyer Index of 20 Municipal Bonds....	13.04	12.28	11.39	9.33	10.06	10.02	9.67	9.87	8.58	11.33	11.51	9.91	9.18
U.S. Government Bonds (Constant Maturity)													
10-Year.............	14.29	13.93	13.12	11.08	11.50	11.04	10.30	10.53	11.46	13.91	13.11	10.85	10.10
20-Year.............	14.27	13.74	12.94	11.14	11.56	11.37	10.98	10.86	11.39	13.72	13.02	11.20	10.54
Mortgage Commitment Rate Conventional Loans....	17.45	17.28	16.75	15.18	14.72	14.46	14.16	14.51	14.00	16.71	16.67	14.46	14.06

Table 15
Critical Factors in the Interest Rate Forecast

	1982				1983				Years				
	I	II	III	IV	I	II	III	IV	1980	1981	1982	1983	1984
Factor													
Fed Policy													
Free Reserves (Bils. of dollars)...........	-1.26	-0.98	-0.38	-0.29	-1.10	-1.19	-0.93	-0.91	-1.14	-1.05	-0.73	-1.03	-0.75
Federal Funds Rate (%).........	14.23	14.51	11.01	9.20	10.17	10.22	9.18	9.85	13.36	16.38	12.24	9.86	9.39
Nonborrowed Reserves %CH.........................	-0.9	4.2	11.7	10.3	5.0	5.0	8.0	8.0	6.1	6.7	5.6	7.3	6.5
Inflation - (%CH - Implicit GNP eflator)..	4.3	4.6	5.4	5.6	6.0	5.3	5.7	6.6	9.3	9.4	6.1	5.6	6.1
The Economy													
Real Growth %CH.........................	-5.1	2.1	0.8	2.1	3.4	3.1	4.5	4.7	-0.4	1.9	-1.5	2.9	4.4
Unemployment Rate (%)..........	8.8	9.5	9.9	10.3	10.2	9.9	9.7	9.4	7.2	7.6	9.6	9.8	8.6
The Dollar													
Morgan Guaranty Trade Weighted Exchange Rate %CH...........................	13.6	15.1	15.1	3.2	-4.0	-4.0	-6.0	-3.0	-0.1	8.9	9.4	0.4	-2.2
Credit Demands (*1) %CH...........................	70.6	-15.8	72.2	35.6	-43.1	-12.3	42.9	44.8	-6.5	4.4	6.8	1.6	27.4
Monetary Growth													
M1 (%CH, SAAR).................	10.8	3.3	3.5	10.6	3.9	2.8	6.9	10.1	7.3	5.0	7.0	5.9	5.1
M2 (%CH, SAAR).................	10.1	9.8	10.1	11.8	6.6	6.4	9.4	9.1	9.2	9.5	10.4	7.8	8.2
Banking System													
Liquidity Tension Index (*2)...	115.1	100.0	74.9	64.9	59.4	85.8	80.4	92.1	78.2	143.1	88.8	79.4	80.7
Federal Deficit (NIA, Bils. of dollars)........	-118.4	-119.6	-157.7	-173.3	-153.5	-147.6	-169.4	-160.3	-61.4	-60.0	-142.2	-157.7	-144.6

(*1) Credit Demands are defined as the domestic credit demands of the household, nonfinancial corporate, and Federal and State and local government sectors.
(*2) The Liquidity Tension Index is based on the changes in bank loans, including C&I loans, plus real estate and individual loans and the flow of total reserves less changes in demand and savings and small-denomination time deposits - index number, 1977:2 = 100.

- A stagnant economy, with weak real economic growth and rising unemployment well into autumn, press interest rates lower.
- Inflation rates move back down toward the new lower plateau established earlier this year and act to keep short- and long-term interest rates lower until near year end. More and more, reductions in expected rates of inflation should help the financial markets.
- The monetary policy stance of the Federal Reserve holds to a relatively tight position so long as the economy does not drop into yet a longer, deeper recession than the severe downturn already in place, and until the sharp declines of inflation are permanent. But the easier tack for monetary policy taken recently should hold well into the fourth quarter even if M1 is somewhat above target.
- Monetary growth remains essentially under control through the rest of the year, with periodic bulges only transitory in the weak economic environment. The January and April bulges in M1 turned out to be a transitory occurrence, the expected summer spike in M1 was a nonevent, and surges this fall will be temporary with the economy so weak. The aggregates, although more broadly defined, become important again in the first half of 1983.
- A resilient dollar, losing only a modest amount of its gains as interest rates work lower, is a positive factor helping to keep U.S. inflation and interest rates down.
- Total credit demands in the private sector ease with the economy in a full-fledged recession this year; there is no big resurgence until 1984. Reliquefication and high savings propensities permit a relatively comfortable absorption of Treasury deficit financing this year.
- Pressure on the banking system should be lessened for the rest of the year and during 1983 as business loan demand eases, helping to keep short-term interest rates down.
- The federal budget deficit and Treasury financing will be at record levels, the biggest negative for the financial markets under the New Fed Policy, but offset to a significant extent by lower rates of inflation, increased velocity growth, and reliquefication by the private sector.

Continuing low inflation rates are a possible escape valve from the potential clash between big deficits, heavy Treasury financing and the restraint of the central bank in 1983 and 1984, with surprisingly low monetary growth an increasingly possible outcome.

The salient qualitative features of the financial forecasts include: 1) declining nominal interest rates, on average, throughout the forecast horizon; 2) historically high nominal, real, and real aftertax returns on savings and costs of borrowing; 3) weak private sector credit demands, especially by business; 4) a gradual, but steady and extended, reliquefication by the private sector; 5) no caving in by the Federal Reserve on achieving sustained lower growth in the monetary aggregate; and 6) a floor under nominal and real interest rates set by huge federal budget deficits, deregulation of deposit and loan rate ceilings, high-cost funding for lending institutions, and risk premia in interest rates from volatility in the financial markets.

Federal Reserve policy has definitely eased with 1) a lower discount rate despite M1 above the upper target limit; 2) a wave of bankruptcies threatening a full-fledged depression; 3) cracks in the domestic and international financial system; 4) a tighter fiscal policy track for the Administration and Congress; and 5) the low single-digit inflation rates now in place.

The temporary abandonment of M1 as a guide to policy makes sense since that measure for money is now so distorted by the effects of seasonal factors, increased liquidity preference, and changes in deposit instruments. Currently, M1 is $9.7 billion above its upper bound and M2 exceeds by $12.3 billion its upper bound. However, M2 as well is undoubtedly distorted, with proceeds of tax cuts flowing into this monetary aggreate and bulging it higher. For the central bank to automatically tighten monetary policy in response to excessive growth in these aggregates when the economy has not yet recovered would be to repeat the mistakes of earlier this year when policy was tightened in January and April in response to transitory changes in the monetary aggregates. In retrospect, the effect of this type of monetarism was to prolong the worldwide recession.

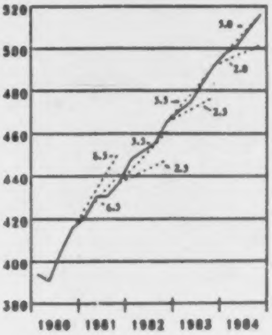
Table 16
Monetary Aggregates: Actual and Targeted

		1982								
	Latest	Sep.	Aug.	July	June	May	Apr.	Mar.	Feb.	Jan.
M1										
Lower Bound	446.98	445.80	444.89	443.98	443.07	442.16	441.25	440.34	439.43	438.52
Actual Monthly Level	467.70	460.50	455.20	451.30	451.40	451.50	452.40	449.30	447.30	448.60
Upper Bound	459.07	456.72	454.71	452.71	450.71	448.71	446.71	444.71	442.70	440.70
M2										
Lower Bound		1,897.35	1,888.31	1,879.28	1,870.24	1,861.21	1,852.17	1,843.14	1,834.10	1,825.07
Actual Monthly Level		1,954.50	1,946.30	1,923.40	1,907.90	1,897.50	1,880.70	1,865.20	1,849.00	1,841.30
Upper Bound		1,942.53	1,928.97	1,915.42	1,901.87	1,888.32	1,874.76	1,861.21	1,847.66	1,834.11

For 1981:4 to 1982:4, targets are as follows:
Lower M1 targeted growth rate:2.5%, Upper growth rate:5.5%
Lower M2 targeted growth rate:6.0%, Upper growth rate:9.0%

The resulting policy course for the Federal Reserve thus will become more eclectic, with a flexible "upper limit" monetarism the goal.

Chart 8
M1 and Its Targets: "Upper Limit Monetarism" (Billions of Dollars, SA)



The "straying from monetarism" of the Federal Reserve has clarified itself more recently. The easing of monetary policy through the temporary abandonment of M1 appears to have been quite modest, with the federal funds rate still trading above 9% and bank reserves and the monetary base actually dropping for the week ending October 13. The central bank is being most vociferous about its adherence to long-run goals of moderate monetary growth and low inflation rates, although hinting that M1 may be abandoned as the vehicle by which these goals are to be achieved. For the moment, direct indicators of the economy, inflation, and unemployment will provide the central bank with the necessary information upon which to base policy. These, after all, are the ultimate targets of the Federal Reserve. M2, M3 and various credit aggregates will be more closely followed. Of course, once the recovery is in place, the central bank will again have to face up to how the monetary aggregates are behaving, perhaps becoming more restrictive if the various aggregates, including M1, are still above target. The "forgiveness" on interest rates now to get recovery going is very likely to mean rises somewhere down the road, once an expansion is in place, unless inflation rates stay quite low.

As for inflation, the back of the price-wage-price spiral of 1965-80 is broken. Inflation rates are primarily down in low single digits, with the key to sustained improvement the performance on wages and productivity growth in 1982 and 1983. The exceptional turn for inflation rates to lower levels is also having a major impact on inflation expectations, with investors in the financial market sensing the fundamentally low pace for inflation now for several years. The permantly lower expected rate of inflation now being discounted into the financial markets is a major reason for the huge rallies since mid-summer.

Chart 9
Consumer Price Index -
All Urban: History and Forecast
(Percent Change)

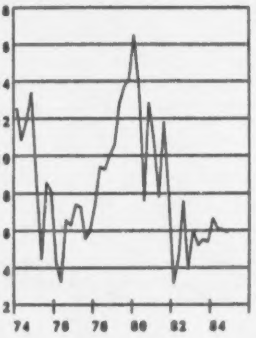
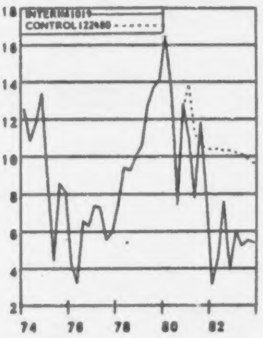


Chart 10
Consumer Price Index
INTERIM1019 vs. CONTROL122480



The prospects suggest that no quick reacceleration of inflation rates is likely. The reasons include:

- Philips curve tradeoff in process on unemployment and inflation— tremendous downward pressure on wages
- record slack in economy—in labor and capital markets, with actual real GNP far short of potential
- anti-inflation policy bias
- food, oil, energy, and shelter costs under control
- productivity growth to rebound.

For the international economies, no recovery appears likely until 1983 and even then only low real economic growth, relatively low inflation rates, and rising joblessness will be major characteristics.

Table 17
International: Major European Economies
(Seasonally Adjusted at Annual Rates)

	1982				1983				Years				
	I	II	III	IV	I	II	III	IV	1980	1981	1982	1983	1984
REAL GDP GROWTH *													
West Germany...	-0.9	-1.4	-0.1	0.3	2.4	2.5	1.9	3.1	1.8	-0.3	-0.2	1.5	3.0
France..........	-0.9	2.4	3.3	2.1	1.1	0.0	1.3	0.1	1.1	0.7	1.7	1.4	2.0
United Kingdom.	4.4	-3.2	2.8	-1.7	3.9	4.1	4.1	7.1	-1.4	-2.0	1.1	2.5	3.6
Product Basis.	-1.5	0.8	2.4	-3.5	2.1	5.0	5.1	7.8	-2.9	-2.5	0.3	2.3	3.7
Italy..........	5.9	-5.4	-4.3	0.0	2.1	4.3	4.5	8.2	3.9	-0.2	0.6	1.5	4.6
GROWTH IN INDUSTRIAL OUTPUT													
West Germany...	5.1	-3.1	-7.8	1.1	1.7	5.5	6.0	3.1	0.0	-2.1	-1.3	1.3	3.4
France..........	-10.8	-2.4	6.0	3.8	2.2	-1.0	-2.0	3.2	-0.2	-1.3	-1.1	1.6	2.5
United Kingdom.	-1.8	0.9	-0.6	0.9	0.3	3.6	3.0	8.1	-6.5	-4.7	0.5	1.8	3.3
Italy..........	-6.3	-0.9	-6.8	-1.0	4.4	3.2	0.3	7.3	5.6	-2.3	-1.8	1.0	3.9
The Netherlands	-7.0	-3.1	4.5	6.2	-6.9	0.0	1.8	3.7	-0.6	-1.6	-0.4	0.1	2.6
Belgium........	9.6	5.3	-4.6	4.8	-3.8	14.8	3.4	6.2	0.0	-6.0	1.4	3.1	2.1
CONSUMER PRICE INFLATION													
West Germany...	3.5	4.7	5.9	2.9	1.6	2.8	6.0	3.0	5.5	5.9	5.1	3.4	4.2
France..........	12.4	13.0	5.7	8.0	15.6	11.9	11.6	9.5	13.5	13.3	12.2	11.2	10.4
United Kingdom.	6.2	9.7	8.5	6.5	3.3	9.5	6.3	9.0	18.0	11.9	9.3	6.8	8.2
Italy..........	16.5	12.4	25.2	8.9	15.2	15.8	15.3	14.8	21.2	19.5	16.6	15.1	14.7
The Netherlands	6.9	4.7	4.1	5.0	5.6	6.3	5.7	3.9	6.5	6.8	6.1	5.3	4.4
Belgium........	6.5	11.9	9.8	8.1	5.6	10.3	7.5	7.4	6.7	7.6	8.8	8.2	7.8
UNEMPLOYMENT (000)													
West Germany...	1627	1773	1911	2053	2164	2206	2151	2108	891	1281	1841	2157	2168
France..........	1948	2002	2007	2016	2014	2060	2100	2107	1447	1768	1993	2070	2184
United Kingdom.	2817	2877	2923	3106	3198	3233	3259	3226	1648	2539	2931	3229	3131
Italy..........	2094	2046	2187	2248	2276	2302	2287	2331	1697	1912	2144	2299	2435
The Netherlands	465	521	553	590	622	643	664	677	248	386	532	652	683
Belgium........	434	466	472	480	497	499	513	529	322	392	463	510	535

* Real GNP Growth in West Germany

Table 18
The Japanese Economy

	CALENDAR YEARS								FISCAL YEARS							
	79	80	81	82	83	84	85	86	79	80	81	82	83	84	85	86
Real Growth Rates																
Gross National Product	5.2	4.2	3.0	2.4	4.0	4.6	4.3	4.7	5.3	3.7	2.7	2.7	4.1	4.6	4.5	5.4
Domestic Demand	6.4	0.6	0.9	1.6	3.2	4.1	4.8	5.1	4.7	0.4	1.1	1.9	3.4	4.3	4.9	5.3
Private Consumption	5.9	0.6	0.7	3.3	3.5	4.3	4.7	6.0	4.6	0.3	1.4	3.2	3.7	4.3	5.1	6.1
Plant & Equip. Investment	11.8	6.5	1.7	1.9	6.9	4.8	3.3	2.6	9.8	5.7	0.7	3.8	6.6	3.5	4.2	2.4
Residential Construction	-1.0	-9.6	-1.1	-3.1	-0.7	10.3	10.2	9.3	-0.1	-10.1	-0.4	-2.3	0.9	10.8	9.8	9.8
Govt.Consumption	4.3	2.3	3.5	0.1	-1.3	-0.6	0.6	2.3	3.5	2.7	3.1	-1.2	-1.3	0.1	0.6	3.1
Govt. Fixed Investment	3.1	-3.5	4.7	-2.2	1.6	1.7	5.0	3.1	-1.0	-0.5	2.6	-0.9	0.7	3.2	4.7	3.7
Exports	6.5	10.7	16.6	6.7	7.2	6.6	4.8	5.2	12.8	16.6	16.0	5.1	7.8	5.6	5.3	6.7
Imports	14.7	-4.0	5.9	3.5	3.8	4.6	7.5	7.6	9.7	-3.9	8.3	1.1	5.4	4.2	8.1	7.0
Ratio Job Offers/Applicants	0.71	0.75	0.68	0.62	0.65	0.77	0.96	1.03	0.75	0.73	0.67	0.59	0.57	0.83	0.96	1.05
Consumer Price Index *	3.6	8.0	4.9	3.2	3.6	4.2	2.1	3.1	4.8	7.8	4.0	3.1	3.8	3.9	2.0	3.0
Wholesale Price Index *	7.3	17.8	1.8	2.1	1.6	2.6	1.4	1.6	12.8	13.3	1.4	2.1	1.2	3.1	0.7	1.9
GNP Deflator *	2.7	2.9	2.9	3.5	2.8	4.0	2.5	3.3	2.0	3.8	2.4	3.2	3.0	4.1	2.1	3.4
Avg. Loan Interest Rate (%)	6.53	8.27	7.85	7.26	6.89	6.42	6.17	6.46	6.85	8.42	7.70	7.12	6.81	6.32	6.19	6.51
Current Balance (Bill $)	-8.8	-10.7	4.8	6.2	13.1	23.1	22.3	17.6	-13.9	-7.0	5.9	5.9	13.3	21.9	17.8	20.2
Compensation per Employee *	6.2	6.1	6.2	5.8	5.8	6.1	5.1	7.3	6.4	6.0	6.1	6.2	5.5	6.4	5.2	7.3
Industrial Production *	8.3	7.0	3.1	2.3	5.5	4.8	4.5	3.8	9.3	4.5	3.7	2.3	5.7	4.8	4.2	3.9
Housing Starts (SAAR,Mill.)	1.49	1.27	1.15	1.11	1.11	1.23	1.36	1.47	1.48	1.21	1.14	1.10	1.13	1.26	1.37	1.50
Yen Exchange Rate (per $)	219	227	221	233	209	196	190	180	230	217	227	230	204	195	187	178

* Annual Rate of Change

The energy outlook is quite positive for the next few years. Low growth in demand should prevent any rise, in real terms, for oil prices until 1984. There will be much less inflation in energy prices, except for natural gas.

Table 19
Energy

	1982				1983				Years				
	I	II	III	IV	I	II	III	IV	1980	1981	1982	1983	1984
Demand For All Fuels - Quadrillion Btu													
Total Energy Demand	72.0	73.8	71.6	71.8	72.2	72.5	73.0	73.3	76.0	73.9	72.3	72.7	74.0
Annual Rate of Change	-3.9	10.6	-11.3	1.3	1.8	2.0	2.5	1.5	-3.6	-2.8	-2.2	0.6	1.7
Real GNP (%Ch)	-5.1	2.1	0.8	3.0	3.0	3.3	3.9	4.6	-0.4	1.9	-1.5	2.9	4.1
Energy Use Ratios:													
Million Btu per Capita	318.7	326.1	315.6	315.9	316.5	317.4	318.6	319.0	341.9	329.4	319.1	317.9	320.3
Thousand Btu Per 1972 $ GNP	48.9	49.9	48.3	48.2	48.0	47.9	47.7	47.3	51.6	49.2	48.8	47.7	46.6
Petroleum and Natural Gas as a Percent of Total Energy Demand	69.5	69.2	69.0	69.0	68.9	68.7	68.5	68.3	71.4	70.0	69.2	68.6	67.3
Prices - Dollars per Barrel													
U.S. Refiners' Acquisition Price for Crude Oil - Composite	33.05	31.04	31.33	31.40	31.43	31.65	31.71	31.86	28.22	35.28	31.71	31.66	34.29
Annual Rate of Change	-13.2	-22.2	3.8	1.0	0.4	2.8	0.8	1.9	59.8	25.0	-10.1	-0.1	8.3
Domestic	32.39	30.35	30.53	30.67	30.78	31.02	31.07	31.21	24.23	34.37	30.99	31.02	33.69
Annual Rate of Change	-12.5	-22.9	2.4	1.9	1.4	3.2	0.6	1.8	69.3	41.9	-9.8	0.1	8.6
Foreign	35.03	32.90	33.28	33.13	32.93	33.05	33.10	33.25	33.97	37.07	33.59	33.08	35.55
Annual Rate of Change	-9.0	-22.2	4.7	-1.8	-2.4	1.5	0.6	1.8	57.8	9.1	-9.4	-1.5	7.5
Foreign - Real (1972 $)	17.20	15.97	15.92	15.60	15.28	15.14	14.96	14.80	19.02	18.98	16.17	15.06	15.26
Annual Rate of Change	-12.7	-25.6	-1.4	-7.6	-8.0	-3.6	-4.6	-4.2	44.9	-0.2	-14.8	-7.0	1.4
Prices - Percent Change													
Wholesale Fuel and Power Price Index	-1.5	-17.9	20.1	1.7	7.2	6.4	5.6	5.6	40.6	21.0	-0.3	5.4	8.9
Coal	14.2	0.9	3.6	6.5	7.9	8.3	8.3	8.6	3.6	6.4	7.9	6.8	8.8
Natural Gas	2.3	7.2	30.5	10.8	20.0	11.6	11.2	11.1	39.8	23.5	11.2	15.3	12.0
Electricity	18.8	4.1	5.7	10.3	13.7	12.9	11.2	10.0	19.0	14.2	11.4	10.7	10.8
Domestic Crude Oil (RSA)	-9.6	-23.3	0.3	1.8	1.4	3.2	0.6	1.8	47.8	44.4	-9.0	-0.2	8.6
Refined Petroleum Products	-4.8	-30.5	27.2	-4.5	1.7	2.6	2.1	2.3	51.7	19.5	-5.3	1.1	6.7
Wholesale Price Index - Industrials	-0.4	-1.9	5.9	3.4	5.8	5.9	6.2	6.8	16.2	10.7	2.7	5.0	7.5
Personal Consumption Deflator - Energy	-4.7	-10.9	17.2	2.4	7.0	6.9	6.1	6.1	29.0	12.2	0.4	5.9	8.1
Gasoline	-14.6	-27.4	24.4	-2.1	3.5	3.8	3.5	3.6	38.6	11.3	-6.6	2.5	6.9
Fuel Oil and Coal	-8.1	-16.1	11.3	1.0	2.6	3.4	3.0	3.2	37.7	21.4	-2.4	2.3	6.7
Electricity	12.2	4.1	5.6	9.4	11.4	11.2	9.8	9.1	15.7	15.0	10.2	9.5	9.4
Natural Gas	25.5	20.2	15.1	14.1	15.6	13.7	12.5	11.6	19.2	13.5	18.5	14.9	12.5
Personal Consumption Deflator	4.9	3.6	7.1	4.9	6.0	5.4	5.5	5.5	10.3	8.6	5.9	5.6	5.8
Gasoline Tax (Cents Per Gallon)	15.0	15.2	15.6	16.3	16.6	16.9	17.1	17.4	13.5	14.5	15.5	17.0	18.0
Federal	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
State & Local	11.0	11.2	11.6	12.3	17.6	12.9	13.1	13.4	9.5	10.5	11.5	13.0	14.0
Real Personal Consumption - Percent Change													
Household Energy Consumption	4.3	-2.5	3.6	-4.9	-0.6	-0.3	0.5	-0.8	-3.8	0.6	1.6	-0.9	-0.3
Gasoline	6.7	15.7	0.2	-6.9	-1.5	-2.2	-1.1	-3.5	-6.2	0.1	4.3	-1.6	-2.6
Fuel Oil and Coal	-28.1	19.3	5.2	-1.9	0.1	-0.4	-0.3	-0.1	-14.7	-14.4	-8.6	1.3	-1.2
Electricity	8.9	-19.2	2.1	2.9	0.9	2.9	3.4	2.8	2.2	6.0	1.3	0.8	3.1
Natural Gas	0.2	-25.8	24.8	-19.2	-1.7	-1.5	-0.8	-0.2	-1.3	-2.5	-3.4	-3.9	-0.3
Total Consumption	2.4	2.5	1.7	3.3	2.6	3.9	3.9	3.4	0.3	1.8	1.0	3.1	3.5
Energy Share of Consumption (%)													
1972 Dollars	5.8	5.7	5.7	5.6	5.6	5.5	5.5	5.4	5.7	5.7	5.7	5.5	5.3
Current Dollars	9.8	9.3	9.6	9.3	9.3	9.2	9.1	9.0	9.7	9.9	9.5	9.2	9.0
Average Miles per Gallon Achieved by New-Model-Year Cars	20.4	20.4	20.4	21.5	21.5	21.5	21.5	22.5	17.4	19.1	20.7	21.8	22.8
Total Gasoline Consumption (Bil. Gallons)	99.4	102.1	103.6	101.9	101.6	101.1	100.9	100.1	101.4	101.4	101.7	100.9	98.6
Gasoline Consumption per Car													
Gallons per Year	932	957	970	954	950	944	939	930	969	958	953	941	911
Percent Change	-5.9	10.9	5.7	-6.4	-1.6	-2.6	-2.0	-4.2	-7.2	-1.1	-0.5	-1.3	-3.2
Imports of Fuels and Lubricants													
Billions of 1967 Dollars	4.8	4.3	5.2	5.1	5.2	5.2	5.4	5.4	6.3	5.6	4.9	5.3	5.6
Billions of Current Dollars	67.7	57.4	70.9	68.8	69.0	70.2	72.1	72.8	83.8	82.1	66.2	71.0	80.3
Import Bill as a Percent of GNP	2.26	1.88	2.29	2.17	2.13	2.12	2.13	2.10	3.19	2.80	2.15	2.12	2.17
Plant and Equipment Investment - Billions of Dollars													
Petroleum	28.6	27.8	26.7	26.2	25.3	24.8	25.4	26.3	20.5	26.4	27.3	25.5	29.7
Public Utilities	40.1	41.4	39.7	39.0	39.1	39.5	40.4	41.5	35.5	38.3	40.0	40.1	44.5
Energy Share of Investment (%)	21.0	21.4	21.0	21.0	20.7	20.3	20.2	20.0	18.9	20.1	21.1	20.3	19.8
Industrial Production - Percent Change													
Oil and Gas Extraction	-7.2	-31.7	-20.7	7.9	5.0	3.3	2.8	1.4	9.5	10.1	-9.1	-1.8	2.0
Piped Gas and Electric Utilities	5.7	-0.9	-0.9	1.0	0.9	2.0	2.1	1.4	1.3	0.6	0.7	1.0	1.8
Total Production	-11.7	-6.8	-3.6	2.4	8.2	8.5	9.1	8.5	-3.6	2.6	-7.6	4.8	7.5
Electric Utility Fuel Use: % From													
Coal	52.3	51.1	51.7	52.1	52.1	52.2	52.3	52.4	49.6	51.6	51.8	52.3	53.0
Natural Gas	14.1	13.7	14.0	14.0	13.9	13.8	13.9	14.0	15.6	15.3	13.9	13.9	13.6
Petroleum Products	8.1	8.3	7.6	7.0	6.4	6.1	5.8	5.5	10.8	9.0	7.8	6.0	4.9
Hydro, Nuclear, Solar, and Exotic	25.4	26.9	26.7	26.9	27.6	27.9	28.0	28.1	24.0	24.2	26.5	27.9	28.5

Corporate profits should rebound in 1983 and 1984 after three consecutive years of declines, but levels will still be chronically low.

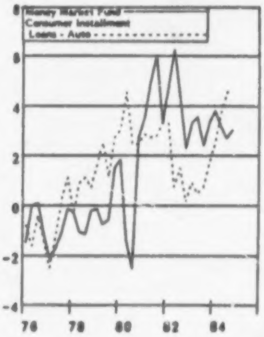
Table 20
Profits: Economy, Sector, Industry
(% chg.)*

	1980	1981	1982	1983
Economy:				
Corporate Profits Before-Tax	-4.0	-4.3	-25.5	13.8
Corporate Profits After-Tax	-4.4	-4.4	-22.5	9.5
Company Profits	-1.2	2.3	-16.0	16.6
Sector:				
Auto Related	NM	NM	2773.8	130.3
Utilities and Communications	9.3	17.5	8.2	7.9
Financial	1.6	-6.4	-2.2	15.8
Miscellaneous Services	5.8	10.6	-2.6	17.1
Consumer-Household	12.1	5.4	-3.6	11.7
Food and Beverages	9.2	16.3	-6.6	12.8
Technology Related	13.6	-2.1	-9.4	12.0
Retail Stores	-7.5	7.5	-12.8	14.6
Miscellaneous Manufacturing	6.5	6.7	-13.4	16.5
Oil Related	11.1	-9.9	-26.1	9.7
Specialty Machinery	-6.8	19.0	-29.6	41.0
Primary Processing Manufacturing	-1.5	9.7	-40.8	20.8
Construction Related	-21.8	-26.9	-48.0	43.0
Metals and Mining	14.4	-49.3	-78.1	166.0
Transportation	NM	NM	-132.0	NM
Industry:				
Auto Related				
Auto Accessories	-30.7	16.6	-24.7	20.5
Tire and Rubber	-51.4	200.1	-50.6	27.1
Automobiles	NM	68.2	NM	502.9
Utilities and Communications				
Gas	13.7	22.3	7.2	10.4
Electric Companies	14.1	17.4	6.6	7.9
Telecommunications	5.7	16.5	5.7	7.3
Financial				
Small Loans	0.2	-29.9	30.5	20.0
Banks	7.8	5.3	-1.8	3.0
Savings & Loans	-56.8	NM	-13.8	NM
Miscellaneous Services				
Restaurants	2.5	18.5	3.5	13.1
Publishing	2.2	10.1	-0.7	15.8
Ratio-TV Broadcasting	0.0	9.0	-1.0	15.0
Vending Machines & Food Services	-2.0	-22.1	-18.3	23.7
Hotel & Motel	31.3	14.7	-18.5	34.9
Consumer-Household				
Medical Supplies & Equipment	12.2	16.4	8.4	5.5
Tobacco	19.4	10.1	3.7	10.5
Cosmetics	5.1	-2.3	2.0	11.7
Drugs	11.9	5.0	0.3	11.7
Soaps	9.1	5.5	-0.6	10.6

*Sector and Industry Ranked Relative to 1982
Source: DRI Industry Financial Service

Despite this cautious optimism on the outlook for the economy, there remains major hurdles to a potential recovery. First, consumers may continue spending very little out of the tax cuts and increase saving considerably, given still strong incentives to save through high interest rates, disincentives to borrow because of high real aftertax borrowing costs, and high unemployment.

Chart 11
Real Aftertax Return on Savings vs. Real Aftertax Cost of Borrowing (Percent)



Second, the mix of economic policy will be a critical ingredient to whether a recovery can be sustained. A "tighter fiscal-easier money" configuration is better than the original "loose fiscal-tight money" policy mix of Reaganomics. This means that the budget must be tightened in January 1983, when the FY1984 budget is presented to Congress. Since further increases of taxes would be detrimental to sustaining the recovery, the most important remaining possibilities are in reducing spending. The 10% tax cuts for next July are important to the expansion, thus the Administration and Congress will have to tackle the entitlements programs as well as the burgeoning expenditures for the military. Tilting the budget toward a tighter configuration with a compensating ease in monetary policy will produce lower interest rates and stimulate interest sensitive areas of the economy, although not necessarily raising overall real GNP.

Table 21 shows the impact on the economy and its major parameters of shifting the mix of policy to a tighter fiscal-easier money configuration.

Third, the potential remains for a clash between worse federal budget deficits and monetary policy in 1983 and 1984. Although most previous years of large deficits have been associated with declining interest rates, a nonaccommodative Federal Reserve policy would suggest the potential for sharply higher interest rates given such large deficits. The key is how much of the new debt is bought by the Federal Reserve, a major buyer in most years of heavy Treasury financing (Tables 22, 23).

Table 21
"Tighter Fiscal-Easier Monetary" Policy Mix: $119.1 Billion Package of Higher Taxes, Lower Expenditures and M1 Growth at Upper Targeted Limits
(Changes relative to baseline simulation "High Deficits")*

	Years		
	1982	1983	1984
Real GNP (% chg.)	0.3	-0.1	-0.3
NIA Deficit (Bils. of dollars, SAAR)	34.3	97.6	140.4
Treasury Debt Issues (Bils. of dollars)	-37.0	-116.6	-184.8
Treasury Bill Rate (%)	-2.0	-3.2	-6.0
New Issue Rate on Corp. Bonds (%)	-1.0	-1.3	-1.6
U.S. Govt. Bond Rate (%)	-0.7	-1.3	-1.8
Mortgage Commitment Rate (%)	-0.6	-1.0	-1.6
GNP Price Deflator (%)	-0.2	-0.1	-0.1
Consumer Price Index - All Urban (%)	-0.4	-0.3	-0.4
Unemployment Rate (%)	0.0	-0.1	0.0
Housing Starts (Mils. of Units)	0.117	0.407	0.610
Business Fixed Investment (Bils. of 72 dollars, SAAR)	1.0	2.7	3.4
Auto Sales (Mils. of Units, SAAR)	0.4	0.5	0.6
Personal Consumption Expenditures (Bils. of 72 dollars, SAAR)	3.7	-0.8	-7.3

*President Reagan is assumed to announce an ex-ante reduction in the federal budget deficit that reaches $119.1 billion by fiscal 1984. Spending reductions of $67.0 billion and rises in taxes of $52.1 billion are recommended and approved. The Federal Reserve provides the reserves necessary to raise M1 to its assumed upper target limits of 5.5%, 5%, and 4.5% for 1982, 1983, and 1984. The tighter fiscal-easier monetary policy mix is assumed to reduce the expected rate of inflation 1.5 percentage points by 1982:4, as the rational expectation to the changes to policy.

Table 22
Deficit and Interest Rates: History and Forecast

	($ Bils.) NIA Deficit	(%) Deficit Relative to GNP	(%) Treasury Bill Rate	New Issue Corporate Bond Rate (%)	U.S. Govt. Bond Rate (%) 20 Year Constant Maturity
1950	9.250	3.2	1.20	NA	NA
1951	6.500	2.0	1.52	3.04	NA
1952	-3.675	-1.1	1.72	3.10	NA
1953	-7.075	-1.9	1.89	3.42	NA
1954	-6.075	-1.7	0.94	2.90	2.64
1955	4.500	1.1	1.73	3.17	2.90
1956	5.975	1.4	2.63	3.68	3.14
1957	2.225	0.5	3.22	4.45	3.54
1958	-10.375	-2.3	1.77	4.02	3.48
1959	-1.125	-0.2	3.39	4.77	4.13
1960	3.025	0.6	2.88	4.68	4.06
1961	-3.875	-0.7	2.35	4.42	3.92
1962	-4.225	-0.7	2.77	4.23	3.99
1963	0.250	0.0	3.16	4.25	4.05
1364	-3.275	-0.5	3.55	4.40	4.19
1965	0.525	0.1	3.95	4.54	4.27
1966	-1.800	-0.2	4.85	5.44	4.77
1967	-13.175	-1.6	4.30	5.77	5.01
1968	-6.075	-0.7	5.33	6.48	5.45
1969	8.425	0.9	6.66	7.68	6.33
1970	-12.425	-1.3	6.39	8.50	6.86
1971	-22.025	-2.0	4.33	7.36	6.12
1972	-16.800	-1.4	4.07	7.16	6.01
1973	-5.575	-0.4	7.03	7.65	7.12
1974	-11.525	-0.8	7.83	8.96	8.05
1975	-69.300	-4.5	5.77	9.01	8.19
1976	-53.100	-3.1	4.97	8.33	7.86
1977	-45.850	-2.4	5.27	8.06	7.67
1978	-29.475	-1.4	7.19	8.88	8.48
1979	-16.100	-0.7	10.07	9.86	9.33
1980	-61.375	-2.3	11.43	12.47	11.39
1981	-59.975	-2.0	14.03	15.01	13.72
1982	-137.703	-4.5	10.48	14.17	13.00
1983	-159.680	-4.8	8.94	11.93	11.07
1984	-151.200	-4.1	9.39	10.94	10.65
1985	-140.255	-3.4	10.30	10.79	10.27

Table 23
Federal Deficit Financing and the Holders: Who Buys the New Debt?
(Billions of Dollars, SAAR, except as otherwise indicated)

	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
NIA Deficit Relative to GNP (%)	1.1	1.4	0.8	-2.3	-0.2	0.6	-0.7	-0.7	0.0	-0.5	0.1	-0.2	-1.6	-0.7	0.9	-1.3
Total Issues (On and off budget; also sponsored agencies)	0.2	-6.3	-0.9	9.0	9.0	-1.7	7.7	8.4	5.6	6.7	3.8	9.2	13.2	17.4	6.2	21.7
Purchased by:																
Federal Reserve	-0.1	0.1	-0.7	2.1	0.3	0.7	1.5	1.9	2.8	3.5	3.7	3.5	4.8	3.8	4.2	5.0
(Percent of total)	NM	NM	73.1	23.6	3.3	NM	18.5	23.2	49.9	51.4	96.5	38.6	36.7	21.7	68.5	23.0
Private Domestic	-0.8	-6.6	-0.3	6.7	5.5	-3.2	5.8	4.8	1.8	3.2	0.1	5.8	6.3	14.1	5.0	6.4
Nonfinancial	7.4	-2.0	0.2	-2.8	13.3	-5.9	-1.0	1.4	4.8	1.0	3.3	7.7	-1.1	8.6	17.7	-7.3
Households	2.4	1.8	0.6	-3.3	5.9	-0.5	0.2	1.0	0.1	2.1	1.9	7.2	1.1	5.7	16.6	-4.6
Corporations	4.1	-4.5	-0.7	0.3	6.1	-6.0	-1.5	-1.8	3.2	-1.3	-1.7	-1.7	-2.5	0.8	-3.1	0.2
States & Localities	1.0	0.7	0.3	0.2	1.3	0.7	0.3	1.4	1.5	0.2	3.1	2.1	0.2	2.2	4.2	-2.9
Financial	-8.2	-4.7	-0.5	9.5	-7.8	2.6	6.9	3.4	-3.0	2.2	-3.2	-1.8	7.4	5.5	-11.0	13.8
Banking	-8.1	-3.5	-0.3	8.8	-8.8	2.5	6.3	1.3	-2.9	0.3	-2.8	-3.1	9.5	3.4	-10.0	10.8
Nonbank Financial	-0.1	-1.2	-0.2	0.7	1.0	0.1	0.6	2.1	-0.1	1.9	-0.4	1.3	-2.1	2.1	1.0	3.0
Rest-of-World	1.1	0.0	0.2	0.1	3.0	0.5	0.5	1.3	0.6	0.4	-0.1	-2.5	2.1	-0.5	-2.0	9.3
Sponsored Credit Agencies	0.1	0.3	-0.1	0.1	0.1	0.1	-0.1	0.4	0.4	-0.4	0.1	0.9	0.0	-0.1	-0.6	1.1

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982F	1983F	1984F
NIA Deficit Relative to GNP (%)	-2.0	-1.4	-0.4	-0.6	-4.5	-3.1	-2.4	-1.6	-0.7	-2.3	-2.0	-4.5	-4.8	-4.1
Total Issues (On and off budget; also sponsored agencies)	30.9	23.6	28.3	31.9	96.9	83.8	79.9	90.5	86.8	122.9	132.6	177.3	226.1	217.4
Purchased By:														
Federal Reserve	8.7	0.4	9.3	5.2	8.4	10.0	7.2	7.3	7.6	4.4	9.8	-2.0*		
(Percent of total)	28.1	1.8	32.8	16.4	8.9	11.9	9.0	8.1	8.9	3.6	7.5	NM		
Private Domestic	-3.5	16.0	18.8	22.5	76.9	60.1	46.1	56.3	91.1	107.2	115.4	190.1*		
Nonfinancial	-10.9	4.2	19.2	19.4	25.4	15.9	24.6	36.3	61.4	38.3	50.4	60.2		
Households	-12.3	0.4	18.9	20.0	16.8	9.7	19.7	29.5	46.7	28.3	36.8	34.8		
Corporations	2.5	-2.1	-3.4	2.3	8.7	2.1	-6.4	-4.5	0.1	-1.2	1.2	3.1		
States & Localities	-1.0	5.9	3.7	-2.9	-2.1	4.1	11.3	11.3	15.6	11.1	12.4	22.3		
Financial	7.3	11.8	-0.4	3.2	51.4	44.8	20.5	18.0	29.7	68.8	65.6	98.9*		
Banking	7.1	6.5	-1.3	0.7	30.0	20.2	-1.1	0.5	7.9	25.6	11.7	8.1		
Nonbank Finance	0.2	5.3	0.9	2.5	21.4	24.6	21.6	17.5	21.8	43.2	53.3	90.8		
Rest-of-World	26.3	8.4	0.2	3.7	8.1	11.6	31.5	28.2	-14.1	10.6	7.1	9.5*		
Sponsored Credit Agencies	-0.5	-1.2	0.0	0.4	1.5	1.5	-3.8	5.6	0.2	0.7	0.4	-4.5		

*Average through 1982:2

Fourth, the potential of a prolonged downturn from the fallout of failures and joblessness cannot be minimized. Both are a cause now as well as a consequence of the current long downturn of the economy, with potentially uncharted impacts on spending since so great a failure fallout has not previously occured in the postwar period.

Fifth, should inflation actually decline, a process of deflation rather than disinflation, the potential for the debt deflation envisioned by Irving Fisher will be enhanced. Already, a considerable number of bankruptcies have arisen because of profit squeezes engendered by lower prices and still high costs, both financial and real. Widespread declines of prices could bring about a crash, similar to the process that occurred in the 1930s.

Finally, the international economic and financial system problem cannot be minimized, especially since the mechanism for imposing austerity on countries in trouble has not yet been established through the IMF and IBRD.

Table 24
Country Risk Threatens the International Financial System

Country	Debt owed ($ Bils. End of 1981)	Due in 1 Year or Less ($ Bils.)**	Exports 1982F ($ Bils.)	Short-term Debt as Percent of Exports
Argentina	25.0	11.8 (47%)	11	107.2
Brazil	53.0	18.6 (35%)	28	66.4
Chile	10.5	4.2 (40%)	5	84.0
East Germany	11.0	6.0 (54.5%)	8	75.0
Mexican	57.0	27.9 (49%)	33	84.5
Peru	5.0	3.0 (60%)	5.5	54.5
Poland	15.0	10.0 (67%)	4.0	250.0
Phillipines	10.2	5.7 (56%)	9.0	63.0
Romania	4.5	2.5 (56%)	5.0	50.0
South Korea	20.0	11.6(58%)	32.0	36.3
Venezuela	26.0	15.9 (61%)	11.0	144.5
Yugoslavia	10.8	7.0 (64.8%)	10.8	64.8

*Source: Morgan Guaranty Trust, New York Times, IMF
**Percent of owed

These risks all add up to a minefield for the economy in coming months and the necessity for a delicate application of policy in order to sustain an economic expansion.

IV. Role of Economic Policy and the Policy Choices

Essentially, Reaganomics and the Federal Reserve policies since 1979 have produced the results and current position of the economy and financial markets. Now, it is a new twist of economic policy over the last six months that is restoring the health of the economy. Just as policy brought about a deep recession of the U.S. economy, so will policy be an essential ingredient to sustained recovery. The tilting of the "loose fiscal-tight monetary" policy mix put in place during 1981 toward a "tighter budget-easier monetary" policy configuration is a major catalyst for the recent improvements of financial markets and eventual recovery of the economy. It will be necessary for a continued tilting of policy in this direction in the months ahead. This will be an important way to sustain lower interest rates, revive the interest rate sensitive depressed industries and areas of the U.S. economy, reverse the prolonged downturn, and to build a base for sustained expansion.

The implication is that the Federal Government must come up with serious new proposals to cut expenditures or raise revenues for FY1984 and FY1985. Without further reductions in transfer payments, in particular entitlements, and a retreat on the military budget, now set to rise at near 7% annual rates, in real terms, a necessary tightening of the budget will be hard to achieve. Lower interest rates should shave $5 to $10 billion from previous estimates of outlays. But without sizeable reductions in military expenditures and new formulas to reduce the pace of rises in entitlements programs, the federal budget deficit appears set for NIA deficits of $150 to $170 billion. The DRI full employment budget model shows a major swing to stimulus in 1983 as a result of the current fiscal programs. .

Additional increases in taxes are still a possibility or postponement of the 10% tax hike scheduled for July 1, 1983, but unless the economy is rising much more rapidly than currently appears, reducing the personal income tax reductions legislated for 1983 should not be attempted.

The best option lies in a somewhat more accommodative stance of monetary policy than had previously been envisioned by the Federal Reserve. The lower interest rates and stronger expansion that would arise from pursuit of a more flexible "upper limit" monetarism would make absorption of the deficit easier and actually encourage a lower federal budget deficit. Through lower interest rates and a stronger expansion, tax receipts would rise, easing the defict problem until a more gradual approach to reducing expenditures could impact. M1 growth as high as 6-1/2% could be permitted without damage to the economy or a major reacceleration of inflation.

The key to getting through the next few years without a major failure of policy lies in the inflation patterns that emerge in the recovery. Should inflation rates hold in low single digits, then the central bank can permit an easier monetary policy, stimulating real economic growth and helping to limit the deficit. If there is a relatively quick reacceleration of inflation, the economy would be thrown back into a stop-go configuration, facing the same insoluble dilemmas as before. Thus, the focus for policy in coming months should swing back to methods by which wage and price inflation can be prevented from reaccelerating at all with so much slack in the economy.

Incomes policies, a TIP, and guidelines remain alternatives worth considering especially given the current slack in the economy. Tax incentives to restrain wage costs, as a "disinflationary" shock, is my own favorite. Micro-oriented policies to hold down wage and price inflation in the backdrop of a gradually recovering economy need to be examined, e.g., a reduction in minimum wages.

There appears to be no other choice than to encourage only a gradual recovery in the economy so that inflation rates will remain low and productivity growth move sharply higher. A large amount of slack in labor markets may well produce a much greater cyclical upswing in productivity growth than is currently expected. This, along with continuing downward pressure on wages, would reduce unit labor costs substantially and permit a long, sustained period of reduced inflation to be in effect. Interest rates could then remain stable for quite some time, permitting a very strong economic expansion toward the mid-1980s. By that time business capital formation would be on-stream again, with supply-side benefits aiding to promote sustained expansion. A gradual expansion has many virtues with the single drawback of sustained high levels of unemployment. Over the longer run, however, unemployment rates might average lower if inflation and interest rates were sustained at relatively low and stable levels for a couple of years.

V. Concluding Comments

The U.S. economy is headed for a recovery because a fundamental turn in the financial markets is underway. The uncertainties now focus upon 1) the lags between the turn in the financial markets this summer and the timing of its impacts on the economy; 2) whether the feedback effects of failure fallout and joblessness on confidence and spending would more than offset the stimulus of the lower interest rates, stronger stock market, and July 1 personal income tax cuts; and 3) the choice of policies to sustain expansion without reigniting inflation. A major reacceleration of inflation would cause any new expansion to be aborted, so must be avoided.

So far, the process since the sharp declines of interest rates began in midsummer appears quite familiar. Large reductions in short- and long-term interest rates preceded a major stock market rally by one to two months. Housing activity and retail sales are beginning to move higher. Balance sheets are being reliquefied, borrowing costs are down, and net worth positions are strengthening. Past experience suggests that impacts on the economy should appear by year end and into early 1983 so long as the Federal Reserve provides accommodation through current levels of interest rates or somewhat lower interest rates. Subsequently, the pace of inflation will be the key to whether the expansion can be sustained. A reacceleration of inflation would bring sizeable rises of interest rates and an aborting of the expansion. Sustained low inflation rates in mid-single digits or below would permit expansion to continue, albeit uneven, but steady throughout the next two years.

The major risks to recovery include the huge fallout of business failures, financial institution difficulties, joblessness, and international financial market repercussions of the long downturn in the U.S. economy. Since the recessions of the past three years were brought about by high interest rates, the particular deterioration in financial positions of institutions in the United States and abroad is dangerous to a potential recovery. A continuing rash of failures, credit losses for financial institutions, foreclosures in the household sector, and default by foreign countries could bring about a mini-version of the 1930s. However, now that the Federal Reserve has begun to accommodate a recovery, the odds on such an event must be assessed at less than several months ago.

The major policy problem for the United States and world economies will most certainly be joblessness. The emerging trends are similiar thoughout the world, generally lower inflation rates and rising unemployment. Of course, this tradeoff has always been a major policy dilemma for the modern industrialized world. But now, a new opportunity affords itself to devise policies to sustain expansion without reaccelerating inflation.

The early years of growth will be relatively easy, since slack in most economies is so great and the downward momentum on inflation so pronounced. But the trick will be to devise macroeconomic and microeconomic policies to accelerate the growth in supply, moderate effective demand, and reduce the core of costs that prop inflation rates. A first necessity is for a restrained expansion in the economy, one that fully permits a complete reliquefication of the private sector and increases in potential output that are not far behind the rises in the real economy. A second pillar of policy will be continued monetary restraint in the form of gradual targeted reductions in the permissable growth for nominal GNP. A third necessity is for a continuing tightening of the federal budget, certainly in spending and perhaps also through raising taxes. Reductions in the indexed entitlement programs are absolutely necessary, the military budget must grow more slowly, and personal income taxes should not be indexed in 1985 and beyond. The costs controls often used in the private sector need to be applied, in a sustained manner, to the public sector.

Finally, another look at wage-price incomes policies is in order. Tax incentives to lower wage costs would produce a disinflationary shock and promote declines in both unemployment and inflation. Microeconomic policies that impact on labor markets and reduce labor costs are another possibility. Lowering the minimum wage is a policy that deserves new consideration.

Will Reaganomics succeed? Table 25 shows the scorecard-to-date, a rather dismal picture of the state of the economy compared with early 1981. The only good grade is on inflation; in virtually every other area the Reaganomics program has not yet succeeded in achieving its goals.

Table 25
Reaganomics: The Scorecard to Date

	1981:1	1982:3E or Latest	Chg. Since 1981:1 (% Chg. or percentage points)
The Economy			
Real GNP (Bils. of 72 $s)	1,507.8	1,481.3	-26.5; -1.8%
Growth Rate	7.9	0.8	
Industrial Production Growth Rate	8.3	-5.9	-14.2; -8.9%
Inflation			
Implicit GNP Deflator % Chg.	10.9	6.2	-3.7
CPI-U % Chg.	9.7	3.3	-6.4
Unemployment Rate	7.4	10.1	2.7
Money and Interest Rates			
M1 (% Chg.)	10.3	10.8**	0.5
Prime Loan Rate (%)	20.2	12.0	-8.2
New High-Grade Corp. Bond Rate (%)	13.5	12.8	-0.7
Stock Market			
S&P 500	132.97	134.44	1.1%
Federal Government			
Nondefense Purchases (Bils. of 72$'s)	36.9	33.7	-3.2; -8.7%
Growth Rate (%)	20.8	20.9	
Defense Purchases (Bils. of 72$'s)	71.0	78.8	7.8; 11.0%
Growth Rate (%)	8.3	2.8	
Federal Spending/Real GNP (Percent)	23.0	24.7	1.7
Deficit (NIA) (Bils. of $)	-39.7	-147.7	-108.0

*1981:1 is first quarter or first month; 1982:3 refers to the latest month available or third quarter estimate.

**September estimate

However, the bottom-line is the finish in 1984, not the start in 1981 or 1982. By then, the DRI forecast shows the major parameters of economic performance moving in the right direction, although not fully successful. There is more room for optimism now that at any other time in the past two or three years, if only the policymakers stay on the current track and external shocks do not interfere with the turn in the economy that now appears to be in prospect.

Representative REUSS. Thank you, Mr. Sinai, and thanks to all the members of the panel.

UNEMPLOYMENT OUTLOOK

It is a depressing tale on unemployment that you all have to tell us. The most optimistic of the five witnesses, Mr. Sinai, says that unemployment is terrible and it's getting worse. He points out that the current rate of 10.1 percent understates the problem and that it actually is something like 14.1 percent. Mr. Sinai further points out that it is going to get worse, and very much worse, if the recovery is anemic.

Is there any member of the panel who thinks Mr. Sinai is being too pessimistic about unemployment?

FOURTH QUARTER GNP GROWTH

Let's look then for a moment at what is being advertised as a ray of hope; namely, the fact that gross national product in the third quarter didn't go down; it barely went up by a hair, according to today's preliminary estimate. But the reason it didn't go down is that inventories were very considerably increased. In other words, the business world believed the Reagan administration when it said that prosperity is just around the corner and a roaring boom is going to happen and then they got ready for it, but now they are stuck with excessive inventories. What does that portend for the fourth quarter in terms of growth?

Mr. EVANS. I think that real GNP will be down approximately 2 percent in the fourth quarter. I think we'll basically have little change in final sales, just as we did this quarter, but that inventory investment will be reduced substantially.

INVENTORY INVESTMENT

Representative REUSS. Aren't business and industry, having shown remarkable faith in Mr. Reagan, increasing inventories in the third quarter, going to believe him when he says that the stock market improvement signifies that recovery is at hand? And aren't they going to increase their inventory even more waiting for the new boom?

I'm trying to get some ray of hope out of this mess.

Mr. EVANS. Well, I think they have pretty much given up. Three months ago when I traveled around the Midwest and talked to clients they were more optimistic than I was. I think in the past 3 months, with no improvement at all in sales in the third quarter, they have become more pessimistic. We see this in the sharp turn in new orders; we see this in the sharp reduction in the Commerce Department survey of business anticipations.

I think most businessmen are now saying for the first time we're going to let somebody else go first, we're just going to retrench and wait for some other sector to lead us out of the slump that we are in and then maybe we will start thinking about expanding.

CONSUMER SPENDING

Representative **Reuss**. Turning to a related point, Mr. Ratajczak made an interesting point when he testified a moment ago that consumption is at a postwar high relative to gross national product.

Mr. **Ratajczak**. Well, at least in terms of post-Korean conflict.

Representative **Reuss**. Post-Korean, right. The last quarter century.

Mr. **Ratajczak**. Last 35 years.

Representative **Reuss**. I'm trying to bring this into focus. Obviously the poor 14 million unemployed aren't adding to consumption; the people who are working in the lower middle class are not adding appreciably to consumption. Could it be that the big buying spree one reads about on Rodeo Drive in Beverly Hills and the great increase in imports of luxury goods, Mercedes and what not, means that Mr. Stockman's Trojan Horse proposition is now coming true? Namely, that with large discretionary income being put in the pockets of the top 5 percent of income receivers they are now spending it in a very, very rapid fashion, and that that answers the mystery of why, when all is gloom, consumer expenditures apparently are at a post-Korean war record high in terms of GNP?

Mr. **Ratajczak**. Well, we have noticed for some time that there has been a split consumer market. The high end and the low end have both shown some strength, the low people going to the discount houses, the high end going into the boutiques, with the middle of the range showing considerable weakness. Lately, however, the high end has started to go to the high end discount houses. So that we are, in fact, starting to see a little bit of convergence there.

Some of the luxury items, such as boats and planes, are deeply depressed, although there is no question that the home entertainment products, the personal computers are well above projections at the current time, and they do get into the consumption stream.

Mr. **Bator**. May I say something about that, Mr. Chairman. I haven't looked at the figures, but one reason why real consumption in relation to the real gross national product is up is because the real gross national product is down, because the other components of the gross national product are down. Business fixed investment is miserable; so is residential investment; net exports are down. The major reason why the consumption-gross national product ratio is up is because the economy is in miserable shape. The built-in counter-cyclical increase in the budget deficit during a recession—a consequence of the decrease in tax collections and the increase in unemployment compensation, et cetera—cushions the decline in personal disposable income. That in turn helps contain the decline in personal consumption.

CAPPING THE 1983 TAX CUT

Representative **Reuss**. You can keep the mike, because I want to turn to a point you made which follows from the progression of our thinking.

You've made the recommendation that the third-year tax cut, the 10 percent due next July 1, 1983, be accelerated to January 1. You obviously make that recommendation with the realization that there will be a lame duck session of Congress. If a certain configuration in the voting patterns appear, the Democrats are likely to be less supine than they have been, and conceive of themselves as people who have some sort of a duty to get unemployment down and not let the terrible situation which you all have painted come to pass.

You've recommended the acceleration of the July 1, 10 percent tax cut to January 1. Would not your recommendation, which I find economically attractive, be even better if you provided that there should be a cap on the tax cuts, so that while the full benefits go to the average person, income recipients making more than $50,000 should have the tax cut leveled off so that they don't get an inordinate addition to the big tax cuts they got in the early years? In the 1981 tax act those with income over $50,000 got a big reduction in the capital gains tax right away, and a huge reduction in the top bracket, from 70 to 50 percent, right away. Wouldn't the billions of dollars that such a cap would realize in revenues be an excellent signal that Congress was serious about getting the out-year budget deficits under somewhat better control?

Sure, you may say yes, but that attack on out-year deficits depends on what you do about spending and a number of other things. But here is an opportunity in this lame duck session to not only bring to focus more demand via accelerating the tax cut now when it is needed, but an opportunity to get the out-year budget in better shape.

Would you accept the Reuss gloss on either proposition?

Mr. **Bator.** If it were entirely a question of fair income distribution, I would like it, Mr. Chairman, especially in the light of what the Reagan-Volcker inflation-curing recession, and the 1981–1982 Federal tax and expenditure changes have done to the distribution of real income. Moreover, a tax reduction aimed at middle and lower income-groups would induce a little more extra consumption spending, and that is the purpose of advancing the effective date to January 1. However, is the Congress likely to adopt a complicated tax measure during late November, as distinct from a simple measure? Advancing the effective date of the personal income tax cuts now scheduled to go into effect on July 1, 1983, so as to make the effective date January 1, seems to me a relatively simple act. I would not I think want to lose the macroeconomic stimulus because the Congress got bogged down in a debate on tax structure and tax reform.

MIX OF FISCAL AND MONETARY POLICY

Representative **Reuss.** Mr. Sinai, your relatively less depressing view of things than your colleagues at the table was due to bits of hope which you obtain from two recent events. You said that the fiscal-monetary policy mix, which was atrocious, with a very loose fiscal policy and a very tight monetary policy, appears to have been improved. Your evidence of that, which I find unexceptionable, is that on the fiscal side Congress, led by Republican Senator Dole, did put a $98 billion revenue raising tax measure on the books, and on the monetary side the Federal Reserve is obviously easing up on its super tight monetarist fetishism. Everybody concedes that.

My question to you is this. In neither the field of supply-side fiscal policy, with which the tax increase is associated, nor in the field of monetary policy, with which the retreat from monetarism is associated, has the perpetrator admitted that they have been doing wrong and showed the slightest sign of permanent attitude improvement.

For example, President Reagan keeps saying he won't yield an inch on military expenditure or on taxes. The Fed persists in stating that there has been no change, that the rule under which they have been operating, which has been "though shalt look at the monetary aggregates and the monetary aggregates alone," is still their rule of life. So I just ask you, doesn't your relatively less gloomy projection encompass a permanent change of attitude, whether self-generated or enforced by outside forces on the part of the perpetrators of the super easy fiscal-super tight monetary policy mix?

Mr. SINAI. Yes, I think actions do speak louder than words, and I have watched very carefully the President's stance on the loose fiscal issue. I recall back in January, I had some very chilling words for this committee, that if they stayed on the same policy track, that is the President and the Chairman of the Fed, that they were risking an unprecedented collapse, unprecedented for the postwar period, and those were very gloomy and chilling words.

We did go through 6 months of that. Unfortunately the compromise, the tilt of policy to a tighter fiscal-easier monetary policy stance didn't come until midyear. I think that is one of the reasons why we are still mired in a no-recovery stage of growth.

But I do think actions speak louder than words, and the President did make a major turn and very publicly supported the higher taxes, and that is significant, because I don't think he can really reverse field again after having reversed field once within a very short time on that issue.

So, I think he is going to be a proponent of tighter budgets, balanced budgets, and really mean that quite seriously for coming months. He may say that he doesn't want to cut military spending and he doesn't want to postpone the tax increase, but I do think the Congress has to be very tough on the military spending side. As an economist and as a layman it is kind of inconceivable to me that there are not efficiencies to be gained in a military budget that's going to grow at 7 percent in real terms for the next 3 years. And I do think the Congress has to stand up and take a very strong stand on that, because that is an area that can be cut. It can be cut without compromising our national defense.

Now, as for Chairman Volcker, too, his actions speak louder than words. I don't think the central bank wants to preside over another Great Depression, or major depression, and the Fed has eased, despite what they say, and I think they will remain accommodating. So there is really a permanent change in their positions. But why?

If you really look at the economic world, there are a couple of fundamental facts of life that make it easier for both the President and Chairman Volcker to take a new stance. It is that inflation rates—we really have broken the back of that horrible inflation of 1965–80. You know, we have so much slack in the economy now and in the labor markets there is virtually no way to reignite inflation fast in the next several years, and in that kind of world the tilting of policy priorities really does change, and I think that has now hit home to the Fed. They have basically mastered the inflation battle and they now have much more leeway to be accommodative and we think they will essentially follow that path. And that's part of the relative optimism on our part here today.

Representative REUSS. You've been a valued adviser of us all for a long time, and I think what I hear you say to us in the Congress is that we've made a good start in telling the Federal Reserve, "Don't just look at the monetary aggregates. That's what has been ruining us." And in telling the revenue authorities, "You've got to collect some more taxes, otherwise the budget deficit is way out of control." Here I refer to Congressman Addabbo of New York, chairman of the Subcommittee on Defense of the Appropriations Committee, who vows that in the lame duck session he will move meaningfully with measures to reduce the rate of increase in military spending.

So those are things that Congress has been doing. I take it what you are saying is that Congress has not been doing all that bad and that you encourage us to attempt more of the same.

Mr. SINAI. Yes; absolutely. The budget impasse was a failure to compromise on the budget and a monetary policy, and it's like all solutions, every side has to give a little bit, and I think you really must stay on that track. Just as proof of it, if you recall, the financial markets turned so negative just after the President's program was passed in the summer of 1981, and then the financial markets really did deteriorate, looking at those large deficits in the face of the new Fed policy, which would not accommodate them.

Notice how well the financial markets reacted the next day after the President made his speech and Congress supported it. In fact, there was bipartisan support of that tax increase. And notice how the financial markets and stock markets have responded to the tilting of policy in the other direction in the summer.

Investors really do know something about the processes by which healing takes place, and I think the President actually can justifiably take some solace in the positive reaction of the financial markets to these moves. I would encourage you to stay on that same track of keeping the budget tight and easing up some more monetary policy.

Representative REUSS. Congressman Mitchell.

WAGE AND PRICE RESTRAINT

Representative MITCHELL. Thank you, Mr. Chairman.

I appreciate hearing from all of you, and I must confess that with the first four witnesses I could not help but think of a bit of scripture that said: "Is there no balm in Gilead; is no physician there?" And then when we get down to Mr. Sinai, he offers us a balm, which is probably just a little bit better than Vasoline or some sort. I must confess that I share your pessimism.

Mr. Bator and Mr. Sinai both alluded to the necessity for some kind of wage restraint, and that may well be required. I'm not sure that it is. But on the other hand, in my opinion prices were abnormally high even before this enormous inflation set in. Why is it that you do not argue for some kind of price restraint also? It seems to me that these two are inexorably linked. Why should we just fall on one side, on wages, rather than looking at the essential linkage? Would you recommend some kind of a price restraint?

Mr. SINAI. Well, my own feeling has been that tax-based incomes policies would be helpful. If we would put that on the wage side we would reduce one of the major cost-push elements in inflation. That plus increased productivity growth would lower unit labor costs and price inflation would fall sufficiently so we would get real wage growth for most people.

The cost-push phenomenon is part of the terrible inflation of 1965–80. That's really perhaps the major reason for that.

Representative MITCHELL. I think I mentioned that in my humble opinion prices were significantly high even before the inflationary spiral set in, and, therefore, it would seem to me to be incumbent on all of us to think about restraining both ends in some fashion.

Mr. Bator, do you have a comment, sir?

Mr. BATOR. Yes, sir. Prices, relative prices, play a very important signaling role in the economy. Much of the jump in the speed of inflation during 1972–75, and 1979–80, was caused by the big increases in the price of oil, food, and other raw materials. The fact that OPEC increased the price of oil was not a good thing for us; it was a very bad thing for us. But since there was nothing we could do to stop them, it was very important that that increase in the real economic cost of oil to the United States be reflected in the final energy prices faced by American businesses and consumers. For that to happen, with other prices generally sticky downwards, the entire price level had to rise. Trying to suppress that kind of transient inflation by controlling prices produces enormous economic inefficiency.

On the other hand, in the absence of any large supply-price shocks like that, and as long as we make effective use of fiscal and monetary policy to avoid excess demand and excessively tight labor and goods markets, the general price level will tend to move in line with normal unit labor costs. If we can make normal unit labor costs slow down, the price level will slow down.

In order to slow down normal unit labor costs, one has to shrink the gap between the rate of increase in money wage rates, and the trend rate of increase in average labor productivity. The rate of increase in trend labor productivity can be altered only very gradually and by small absolute amounts. That leaves wages. There are only two ways to slow down wage increases. One way is to use fiscal and monetary policy to produce a recession and an awful lot of unemployment. That is what we are doing now. It is a very costly method. The alternative would be to restrain wages directly by some kind of a wages policy.

Now, why not be fair and put controls on prices also? The danger is that if we do adopt some kind of price controls as well, as distinct from very general price oversight, we will interfere with the working of relative prices. That would soon produce a mess of shortages and excess supplies. After a year or two, the control system would become discredited. That's what we did in 1971–73.

To balance wage restraint in a politically acceptable way, we should perhaps think about controlling dividends. It's not clear that that would do very much harm. But I would be very careful about imposing any kind of direct restraint on prices. It might once again discredit the whole scheme.

Representative MITCHELL. Let me say that I certainly was not envisioning or contemplating a kind of a wage-price control fixed in some bureaucratic setup. You suggested wage restraint, and I'm merely suggesting price restraint. Perhaps I'm just being obstinate this morning, but as a tyro in this field of economics I find myself in disagreement with you.

And as an aside, I must point out that it's almost un-American to talk about 6-percent unemployment as being acceptable, but that's what we're doing right now.

RELIQUEFICATION

Mr. Dalio, I was fascinated by your testimony. You were even more grim than the ghost of Hamlet's father in these proceedings. But I was struck by something. It was really very important, it seems to me, and that was your statement that we had to move immediately, we had to achieve immediate reliquefication, and I think almost everybody on the panel would agree with that. But how? How do we do this? If you were captain of the *Titanic*, what orders would you give in order to achieve immediate reliquefication?

Mr. DALIO. I think one of the things that we have got to recognize—I would say I would be in agreement and disagreement with Mr. Sinai. I would be in agreement in that monetary policy has basically been myopic in that it looks at aggregates when it is interested in fighting inflation, and it looks at interest rates when it is interested in trying to stimulate the economy.

Instead, it would be a good idea if they looked beyond those targets and perhaps set levels of economic activity and levels of inflation as targets. And if you did that when the economy was too weak and inflation, you were oversucceeding your battle with inflation, had a lower level of inflation, then you might be more inclined to turn stimulative. In fact, if they had followed those policies they would have turned stimulative before; they wouldn't have made the error, which I think is most fundamental, of perhaps overlooking the decline in the velocity of money.

Where I would disagree with Mr. Sinai is in the fundamental tradeoff between inflation and economic activity. When we have high levels of inflation, that is the primary target, and we find our way of how we can keep the economy robust while we dispose of inflation, and now when we dispose of inflation we see how we can stimulate the economy without rekindling it.

If you turn to chart 4—I think there are some fundamental relationship here. Chart 4 is at the rear of my prepared statement. Although it has been mentioned that inflation got a goose up because of the bad harvests and the oil crisis, I should like to point out by observing chart 6 that there has been a steady increase in the rate of inflation, from 2 percent in the 1950's, from 3 percent on average in the 1960's, 7 percent on average in the 1970's, and then we had the sharp increase at the appointment of Paul Volcker.

In fact, the level of inflation doesn't necessarily have to reflect higher oil prices or higher costs, because if money supply were kept constant, if we lived in a world where people had the same number of dollars to spend, so to speak, although they would have to be spending more dollars for oil, they would have to by constraint, or the restriction of the number of dollars, spend less money elsewhere. So that most of the movements in the inflation rate are directly attributable to movements in the money supply.

The economy now is so illiquid—I think that this is one of the most important things. We all agree that the outlook is essentially for a flat economy.

What are the implications of a flat economy? How long can the economy sustain operating at 70 percent of capacity, or less than 70 percent of capacity, without triggering a bankruptcy crisis? What are the implications?

My numbers show that you would have a 50-percent increase over the next 6 months in business failures as a result of a flat economy. How long can the steel industry operate at 39 percent of capacity and so on?

In answer to your question, I would say that if I were sitting in that position I would try to formulate a policy that recognizes that there is a tradeoff between inflation and rate of economic activity, and that I would try to set targets for both economic activity and the inflation rate, and any time the inflation rate fell below those targets and the economy was weaker I would turn more stimulative.

I would like to add one point. As far as the Federal Reserve becoming stimulative, there are various degrees to what that could mean; there are various degrees to becoming stimulative. I think we have an economy which is teetering on what I call failure. In other words, if lenders become more cautious about making loans, and if the flow of money to those who need it the most is constricted because of the high failure rate, you will have a bankruptcy crisis which the economy as a whole can't avoid.

The Fed has basically taken a posture—you can see it in open market operations and so on—of turning very modestly stimulative. By that I mean they will come in the market as net buyers when Fed funds get down on the order of 9¼ percent and the like. So they have turned very, very modestly stimulative. To me the risk is so much greater of a downturn from these levels than an upturn from these levels and inflation being rekindled. The fact that there has been virtually no response to the stimulation that has taken place so far—if anything, you look at the numbers, there's weakness—would seem to indicate to me above all else we have to avoid the possibility of a sharp decline in economic activities from these levels caused by a bankruptcy crisis.

So if I was running monetary policy I would definitely run it with the hope of trying to avoid that type of error, becoming much more stimulative.

I also agree that too much attention is being placed on the aggregates and not enough attention on the velocity of money and not enough attention on credit as a whole. So that I would like to see more attention being given to nominal GNP rather than just simply the money supply components of that.

Representative MITCHELL. Mr. Bator seems to be involved in disagreement, and before you respond—I know that the hour is late, and I have made copious notes, have many questions—I would like to raise just one more question in another area after my friend who is involved in apparent violent disagreement with you has an opportunity to speak.

Mr. Bator, weren't you in disagreement? You seemed to be in disagreement with several of the things that Mr. Dalio had to say. Or was I misreading you?

Mr. BATOR. I liked Mr. Dalio's conclusion, sir. What he said at the very beginning troubled me a little. It also shows up in his prepared statement. And that is the notion that somehow the Fed faces a terrible dilemma.

In order to support a decent recovery, business balance sheets have to be—it's a terrible word—"reliquefied." I agree. The Fed's role in that is to make sure that the supply of money grows fast enough to keep real interest rates from going up and, in my judgment, fast enough to make real interest rates go down some more. To support even a very moderate recovery: 1 point a year improvement in the unemployment rate, real output has to grow by 4 to 5 percent each year. With the core inflation stuck, I believe, along that path at, say, around 5 to 6 percent, total nominal spending would have to grow at 9 to 12 percent. For that, the Fed would have to increase the money supply a lot faster than by 5 percent a year.

The question is: Will such a faster growth in money supply necessarily rekindle inflation in the sense of making the core inflation rate go up again? That is where I disagree with my colleague. There is no automatic year-by-year connection between money supply growth and the price level. The current rate of change in the price level is a function of the recent rate of change of inflation, and tightness in labor and goods markets. My judgment would be that if, during the next 3 years, we follow a path of gradual recovery, 4 or 5 percent real growth a year, and a consequent reduction in the unemployment rate by a point a year, that then, whereas the underlying rate of inflation would probably not improve, I doubt that it would get much worse. It would not get much worse even though money supply would be growing at 7 or 8 percent. Of course, if we should get hit by another big increase in oil prices, all bets would be off.

So, assuming no oil price shock, I would be a good deal more optimistic than Mr. Dalio with respect to the inflation-recovery tradeoff. Money supply growth fast enough to support real growth of 4½ to 5 percent during the next 3 years would not, in my opinion, cause inflation to reaccelerate.

Representative MITCHELL. Of course, I'm a little discouraged, though, when you talk about a modest reduction in unemployment. Because unless this Nation had abandoned all its compassion and sympathy, a 1-percent reduction in unemployment is going to still leave us paying out $25 billion to $30 billion for the other 10 percent. Therefore you are almost building into your fiscal side a permanent kind of burden that would obviously be alleviated or diminished if we were more vigorous in our pursuit of reducing unemployment.

FEDERAL RESERVE POLICY

Let me just get in one other statement. It seems inevitably threaded throughout your testimony and the question and answer period that we come back to that pristine, pure, Promethean entity in Government known as the Federal Reserve. And you, Mr. Sinai, have indicated that you believe the Fed has shifted, will retain that shift and will sustain a policy that would be supportive of a recovery. Yet, at best, someone has described Mr. Volcker as being characterized by ambiguity. At worst he has been described as being locked into an inflexible position. I just have some concern about your optimism, primarily because it seems to me that you are assuming that this recent shift was absolutely devoid of any political implications. You know what I mean.

Mr. SINAI. That's really something I can't speculate on.

Representative MITCHELL. Well, I think we are forced to speculate on that.

Mr. SINAI. There is a coincidence there. But the facts of the state of the economy——

Representative MITCHELL. Well, I'm almost ready to assume that there is a correlation, but be that as it may.

Mr. SINAI. The lack of recovery and the state of the economy and the improvement on inflation was so great that I think any central banker—and I think this is more than Chairman Volcker—would feel a little foolish in pursuing a policy that said "thou shalt decrease reserves and increase interest rates" when they could see full well what the state of the world was. Now the fact that it falls 1½ months before the elections may or may not be the reason why they did it. But the economic facts of life were very clear, and the Federal Reserve did what a central bank should. It doesn't want to preside over a major depression.

The question of permanence of that, I think again they will find out as they study it—and I think they are finding this out already—that the policy they followed that worked so well to cut inflation rates down so fast, faster than anyone expected, are just no longer appropriate in the kind of economy we now have, and they will find a way to tilt not fully away from the new Fed policy of October 1979, but in a direction that will give us a recovery that we can all see. Then at that point they have another problem to reassess.

Representative MITCHELL. Well, I just hope your speculation is right. I recall under Chairman Burns, when there was some slight variation in monetary policy at the prodding of the Congress, and then at the first opportunity he immediately seized the chance to revert to a money policy that I think was inimical to the economic growth of this country.

Maybe you're right.

Mr. SINAI. Well, you know, Congress has the responsibility to keep offering its views and advice. With regard to monetary policy and fiscal policy and the budget, I would encourage the Congress to take very forceful stands on what you think is right. It can have an impact, and you should do it.

Representative MITCHELL. I thank you, and I thank you for your faith in Chairman Volcker's rebornness in monetary policy. I hope you are right. I have reason to suspect that you are not.

Thank you, Mr. Chairman.

Representative REUSS. Thank you, Mr. Bator, Mr. Dalio, Mr. Evans, Mr. Ratajczak, and Mr. Sinai. You have, as we expected when we invited you, contributed enormously to our education and helped us in our determination to do a little better in the future, starting right in the lame duck session.

We now stand in recess.

[Whereupon, at 12:25 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, November 24, 1982.]

[The following information was subsequently supplied for the record:]

SHARE THE WORK COALITION

We represent the twenty million unemployed persons of the Free World

Wallace D. Barlow
Executive Director

8210 Massachusetts Ave.
Washington, D.C. 20016

Tel: (301) 229-6066
Cables: Intresecon

PREPARED STATEMENT OF WALLACE D. BARLOW, EXECUTIVE DIRECTOR, SHARE THE WORK COALITION, FOR THE JOINT ECONOMIC COMMITTEE OF THE UNITED STATES CONGRESS.

Subject: The Unemployment Problem

We are strongly opposed to the many temporary solutions which have been proposed for the unemployment problem. We are not dealing with a situation that changes with the business cycle. The real need is for job careers, not for temporary jobs.

A summary of our proposal follows:

"The simple, cheap solution to the unemployment problem is to increase the labor content of the goods and services we produce. This can best be done by a discriminatory corporation tax. The rates would be inversely proportional to the labor content of each industry. The industries that employ many humans and very few robots, would enjoy a much lower corporation tax.

For sixty-five years, the corporation tax burden has been carried on the backs of the labor-intensive industries. (In 1980, the taxes actually paid were at the rate of 33% for the labor-intensive industries and only 19% for the capital-intensive industries.)

The Share the Work Coalition now proposes legislation to TILT THIS TAX IN THE OPPOSITE DIRECTION! The result: The employers, in order to survive, would chose more labor-intensive modes of production. This CAN be done, without wiping out the "high technology" industries. The cost? Zero; since the average corporation tax rate would remain at 46%."

In the last election we polled the Federal candidates. The affirmative vote of the respondents was in the high 80's. An adequate number of the winners are pledged to the support of "TILT".

We respectfully request that this letter and the attached article, "FEDERAL TAXATION IS TILTED IN FAVOR OF THE CAPITAL INTENSIVE INDUSTRIES" be inserted into the record of your October 15/16 hearings.

Very truly yours,

Wallace D. Barlow

Wallace D. Barlow

Enc: Article presented at the Atlantic Economic Conference on October 10th, 1982.

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INTERNATIONAL INSTITUTE
for
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FEDERAL TAXATION IS TILTED IN FAVOR OF THE CAPITAL INTENSIVE INDUSTRIES

By Wallace D. Barlow

For presentation at the Miami Beach Conference
of the
Atlantic Economic Society

October 7-10, 1982
Konover Hotel
Miami Beach, Florida

NOT for release to the press before 10 A.M. on October 10th, 1982

FEDERAL TAXATION IS TILTED IN FAVOR OF THE CAPITAL-INTENSIVE INDUSTRIES

By Wallace D. Barlow
Director, INTERNATIONAL INSTITUTE FOR RESOURCE ECONOMICS

Figure One shows that the corporation taxes actually paid by the average labor-intensive industry in 1980 amounted to a rate of 32.7% of net earnings; (The statutory rate is 46%). The average capital intensive industry paid only 18.8%. We see that the labor-intensive industries are paying almost twice as much in corporation taxes as their competitors. Therefore, a million dollars spent by a very high labor content industry creates almost six times as many job careers as a very low labor content industry. (These data are from the U.S. Commerce Department and the U.S. Treasury Department.)

This gross discrimination has been going on for sixty-five years. It started in 1917, when the War Excess Profits Tax granted corporations a deduction of 8% of their invested capital. (In 1915 the rates of tax were 4% for individuals and 6% for corporations.) Since 1962, there has been a veritable bonanza for the firms that invest in short-lived equipment. The Kennedy administration increased these subsidies, as did the Nixon administration and the Reagan administration.(President Reagan's 1982 Economic Report to the Congress lists Mining, Motor Vehicles and Transportation Equipment as having negative corporation tax rates. These rates can be as high as 11.3%.)

The cost of these subsidies is now approaching thirty billion per year. In these years, since 1917, the average labor content of U.S. industry fell from 38% to 27%. (It was 46% in 1870). Today, the worker is faced with robots having fifteen times the productivity of humans and costing only one-third as much in wage equivalent.

Figure Two confirms Figure One. It shows the correlation between the corporation tax actually paid by typical U.S. industries and the labor content of these industries. Both variables are shown as percentages of the maximum. Accordingly, a vertical line at the center of the page would have the capital-intensive industries on its left and the labor-intensive industies on its right. The coefficient of correlation, (r) = .754.

In 1980, the labor content of U.S. industries varied from 12.7% for Oil and Gas Extraction to 69.9% for Holding and Other Investment Companies. A selective approach, based on labor content, is surely a better approach than the shotgun approach of conventional legislation.

Let's look at Table One, which shows typical labor contents in the top and bottom deciles:

Table One

WAGES AS A PERCENTAGE OF VALUE ADDED IN THE UNITED STATES - 1980 1/

Part A - The Top Decile - Typical Labor-Intensive Industries

Industry	SIC Number	Wages as a % of Value Added
Ship or Boat Building or Repairing	373	56.4%
Rubber and Plastic Hose and Belting	3041	52.8
Iron and Steel Foundries	332	51.9
Rubber and Plastic Footwear	3021	51.1
Ordnance and Accessories	348	50.8
Aircraft and Parts	372	50.6
Weaving Mills, Cotton	2211	49.8
Nonferrous Foundries	336	49.5

Part B - The Bottom Decile - Typical Capital-Intensive Industries

Industry	SIC Number	Wages as a % of Value Added
Agricultural Chemicals	287	19.6%
Cigarettes	2111	15.5
Petroleum Refining	2911	15.3
Pipelines, except Natural Gas	46	15.2
Soaps, Cleaners and Toilet Goods	284	14.9
Oil and Gas Extraction	13	12.7

1/ "Labor Content of U.S. Industries", Share the Work Coalition, 1981

FIGURE ONE
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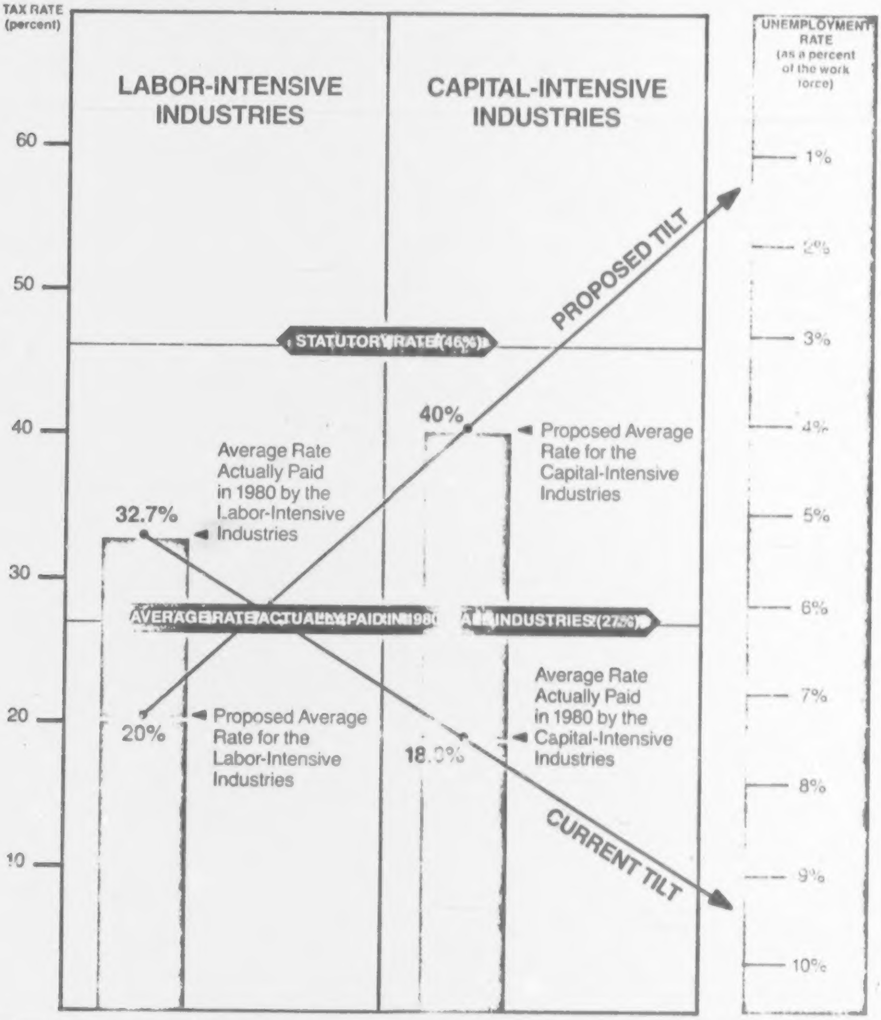
TILT the U.S. Corporation Tax!

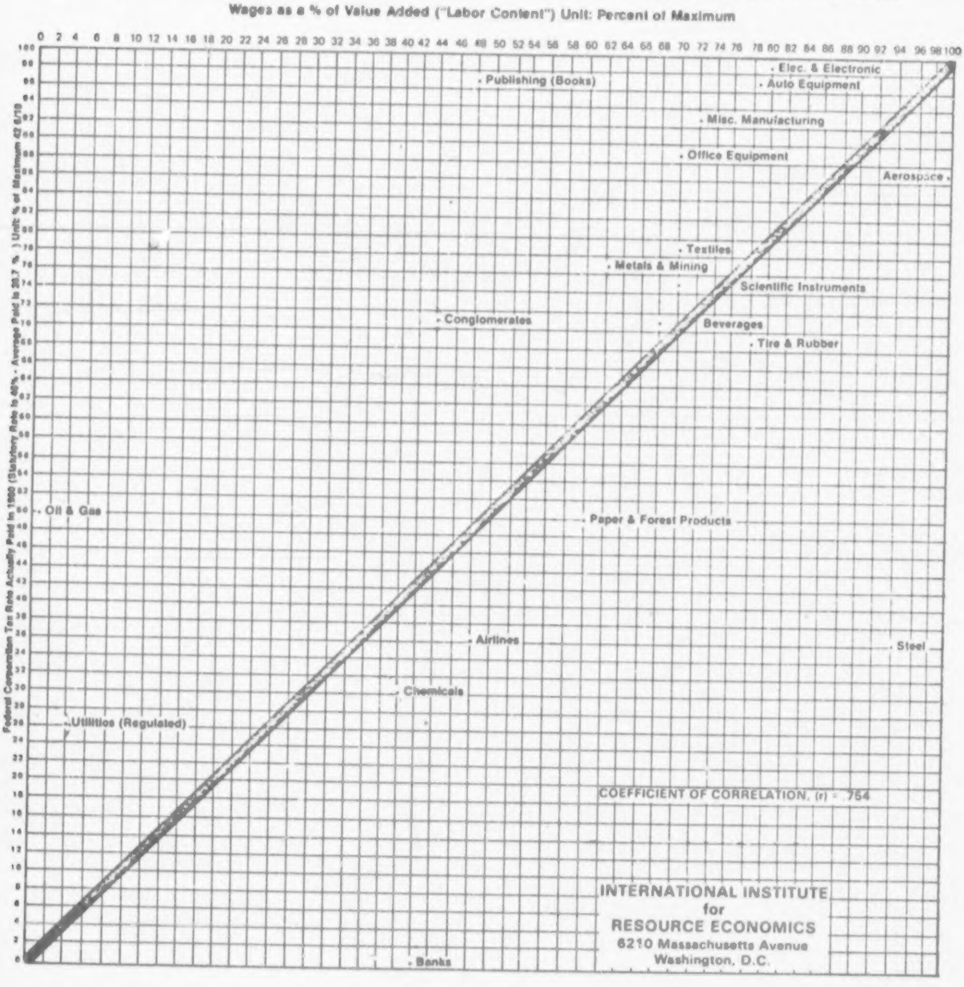
For 65 years the Federal Government has been tilting the corporation tax in favor of the capital-intensive industries. A tilt in favor of the labor-intensive industries would solve the unemployment problems of the free world.



INTERNATIONAL INSTITUTE FOR RESOURCE ECONOMICS • 6210 MASSACHUSETTS AVENUE • WASHINGTON, D C

FIGURE TWO
****

CORRELATION BETWEEN CORPORATION TAX ACTUALLY PAID IN 1980 AND THE LABOR CONTENT OF THE INDUSTRY PAYING THE TAX



I visualize our task as economists as the improvement of the quality of life on this planet. A part of the quality of life is the right to the satisfactions that come from participating in the production of goods and services. I hold that 40% unemployment among black teen-agers is dangerous, inhuman and intolerable. In the Free World there are now twenty-five million persons unemployed.

In our poll, taken in 1976, 82% of the respondents, all candidates for federal office, answered YES to the question, " I believe that the right to employment is a basic human right." In 1980, the same group was polled. The affirmative vote was 100%.

In my judgement, the free enterprise system will be abandoned within ten years, unless action is taken to deal with what Samuelson defines as "structural unemployment". His discussion of this problem concludes: "Increasing the fraction employed at what is defined as feasible full employment would be a powerful way of increasing the quantity of labor and would be conducive to growth. (Its social benefits would, of course, outweigh its mere growth benefits.)" Since this was written it has become apparent that the survival of the free enterprise system itself is at stake.

Under socialism, an effort is made to share the work. The socialist nations also try to provide free health insurance and adequate pensions. I suggest that we consider borrowing the share the work principle without compromising the free enterprise system and without a loss of efficiency.

In England, in 1538, the concept of using taxation to achieve economic objectives was conceived. Our proposal, known as "TILT", is the most radical application of this principle since 1538. It is revolutionary. We propose to TILT THE CORPORATION TAX IN THE OPPOSITE DIRECTION. It is brutally simple and we expect it to be highly effective. The only way to control unemployment is to INCREASE THE LABOR CONTENT OF GOODS AND SERVICES. The most effective way to increase the labor content is to make it worthwhile for the employers to adopt more labor intensive modes of operation. Every proposal to buy equipment fits into the following pattern: "We want to spend x dollars for equipment. This will eliminate y dollars in wages. The net gain is z dollars." When TILT is adopted, z will become negative, after taxes, in many instances.

Figure One approximates the proposed effective tax rates at 40% for the capital-intensive industries and an average of 20% for the labor-intensive industries. The actual tax rates would be an inverse function of wages as a percentage of value added. Table III of "Labor Content of U.S. Industries", a booklet published in 1981 by the Share the Work Coalition, lists the labor content of U.S. industries, their SIC number and our proposed corporation tax rate. The range of the proposed statutory rates is from 30% to 62%. The degree of tilt would be changed from year to year, to provide the necessary "fine tuning"; also to provide equitable treatment for employers who may have changed their labor content during the year.

The corporation tax would continue to yield about fifty billion per year, but resources would be transferred from the automated industries to the non-automated. The impact on the consumer would be that he would pay more for his cigarettes and less for his T-shirts.

It appears that all industrialized countries have a corporation tax. The level varies from fifty-two percent in the United Kingdom to 30% in Italy. In West Germany a 1977 law established a range from fifty-six percent to forty-four percent. In the United States, the rate for large corporations is 46%. In all industrialized countries a part of this tax is passed on to the consumer in the form of higher prices. The balance is passed on to the stockholders in the form of lower dividends.

Table Two gives the latest figures on unemployment for the industrialized nations, adjusted to U.S. concepts. It is no coincidence that the nations having the lowest unemployment, do NOT have investment tax credits.

TABLE TWO
****

UNEMPLOYMENT RATES IN THE INDUSTRIALIZED FREE WORLD

Nation	Unemployment Rate in Percent		Investment Tax Credit?
Great Britain	13.8%		Yes
Canada	11.9		"
United States	9.8	(Average = 8.90%)	"
Italy	9.3		"
France	8.7		"
West Germany	7.6		No
Japan	5.7	(Average = 6.65%)	"

I have discussed this plan with the White House. They showed interest, but were concerned about possible losses of productivity. They are right, in a sense, since UNIT productivity will fall under any plan for sharing the work - untrained persons will enter the work force. Total production will rise, of course, since the work force will be larger. I hold that unit productivity is not sacred. The survival of the free enterprise system is far more important.

The reaction of a friend who represents General Motors in Washington was this: "This would wipe us out." The U.S. Chamber of Commerce said, " By definition, half of our membership will be opposed". Other persons claim to favor "tax neutrality". These are the real dreamers.

Part Two of my paper deals with the seventy percent of the work force which is employed by the service industries. The "tilting" of the corporation tax will surely benefit these persons. However, a direct approach is also suggested. This must involve the shortening of the work week or the work year. In addition to "flexitime" and the 32 hour week, there has been progress in one plan for shortening the work year. Three plans have been suggested for the reform of the antiquated Gregorian Calendar, which has been a heavy burden for the Western World since 1582. In the 19th Century two plans were suggested; the equal months plan and the equal quarters plan. (Comte and Armelin were the inventors. In the 20th Century, a third plan was suggested. It has equal months and equal quarters. It would also triple the holidays, thereby reducing the length of the work year by 5.5%. The details are shown on Page 7, an excerpt from "Future Facts", by Stephen Rosen.

Calendar Reform
Political Action Group

THE
BARLOW
CALENDAR

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Executive Director
Wallace D. Barlow

Calendar Reform

On what date will Easter fall next year? On what day of the week is your birthday? For the answers you'll have to consult your calendar. As an alternative, however, several organizations recommend settling these questions of timing once and for all. They propose a variety of reforms—from regularizing the Gregorian calendar to scrapping it altogether.

The Western calendar is a hand-me-down from the ancient Egyptians, who adopted a solar calendar in 4236 B.C. The Romans had a ten-month system until 46 B.C., when Julius Caesar remodeled it after the Egyptian pattern. Pope Gregory XIII revised it again in A.D. 1582 to stabilize the date of the spring equinox. Still irregularities remain.

One inconsistency that peeves computers is the wide variation in the number of working days in each month. First, there's the problem of whether the month has 28, 29, 30 or 31 days. Then the machine must worry about how many weekends there are. Finally, there are the holidays to consider. The total number of working days can vary as much as 19 percent.

As far back as 1849, the French philosopher Comte proposed what is now known as the International Fixed Calendar. He suggested a year divided into 13 months, each exactly 28 days long; the extra month, Sol, would be squeezed between June and July. To make a total of 365 days, an extracalendar holiday, with no designation as to month or day, would occur after December 28. In leap year there would be a second extracalendar feast. The first day of every month would always be a Sunday, and the last a Saturday. Unfortunately, Comte's year would not divide evenly into quarters, a major drawback from a business viewpoint.

The World Calendar, devised by the French astronomer Armelin in 1884, keeps the 12-month system and equalizes the quarters. Every quarter has 91 days: January, April, July and October have 31 days, and all other months have 30. The provisions for a 365th day and leap year resemble Comte's calendar. Although during the 1930s, 47 nations endorsed the concept of the World Calendar, no action was taken. Two recurring criticisms have been that each month spans parts of five different weeks, and each month of a given quarter begins on a different day.

An American industrial engineer, Wallace Barlow, has extended the idea of the extracalendar day into 29 extracalendar days. He conceives of a working month of 28 days; every month begins on Monday, and there are no holidays (except Saturdays and Sundays) in this period. All holidays are gathered together into a series of extracalendar festivals at the end of each month. The Christmas holiday, for instance, begins on Saturday, December 27, and runs through the 28th and five extracalendar feast days. The total work year is shortened by 14 days, but Barlow argues productivity will actually increase because there are no "broken weeks" (midweek holidays). This is the equivalent of reducing the workweek to 35 hours.

A first step to calendar reform in the United States was the passage of the Monday holiday bill. Polls show over 90 percent of the population support this change. The Calendar Reform Foundation, which endorses the Barlow Calendar, advocates setting a fixed date for Easter, and changing Christmas and Thanksgiving so they too are Monday holidays. The Vatican's ecumenical council has voted overwhelmingly not to oppose a fixed date for Easter or a perpetual calendar.

"The cost of accomplishing this calendar reform is substantially nil," the Calendar Reform Foundation reports. "The savings in the cost of accounting operations alone will approximate $1.5 billion; however, as Maurice Maeterlinck wrote, 'At every crossway on the road that leads to the future . . . each progressive spirit is opposed by a thousand men appointed to guard the past.'"

THE BARLOW CALENDAR

M	T	W	T	F	S	S
1	2	3	4	5	6	7
8	9	10	11	12	13	14
15	16	17	18	19	20	21
22	23	24	25	26	27	28

every month is the same,
except that the 28th of April is Easter Sunday

The Extra-calendar Days

	all are holidays and follow weekends
January 29th	Winter Festival
February 29th	National Hero's Day
March 29th	Spring Festival
April 29th, 30th, and 31st	Easter Holiday
May 29th, 30th 31st, 32nd (and 33rd on Leap Year)	Summer Festival
June 29th, 30th, 31st, and 32nd	Festival of Peace
July 29th, 30th and 31st	Festival of Independence
August 29th and 30th	Festival of Friendship
September 29th and 30th	Autumn Festival
October 29th	Nobel Festival
November 29th and 30th	Thanksgiving Holiday
December 29th, 30th, 31st, 32nd, and 33rd	Christmas Holiday

The Barlow Calendar has 12 months of 28 days each and a series of extra-calendar holidays that would fall at the end of each month.

Excerpt from "Future Facts" by Stephen Rosen
Published by Simon & Schuster, NY 10020

The latter plan has been adopted, in part, by the Soviet Union and Brazil. Such a shortening of the work year could create eighteen million jobs in the Free World, of which six million would be created in the United States.

From time to time bills are introduced into the U.S. Congress which would finance a study of these calendar reform proposals. The supporters of such bills have noted a strong inverse correlation between the number of holidays in the nations of the industrialized Free World and the levels of unemployment. For example, the United States has 16 holidays, (including the two week summer vacation), and 9.8% unemployment. West Germany has 27 holidays and 7.6% unemployment. Sweden has 29 holidays and 3.5% unemployment.

May I conclude with a brief cost-benefit analysis:

I. The present system is costing about twenty-six billion per year in unemployment benefits and five billion in investment tax credits. We are therefore squandering thirty-one billion per year to destroy the work ethic and to create a caste system in America. Children are conceived for the purpose of qualifying for ADC, (Aid to Dependent Children). They are born and raised on welfare. Upon maturity, they accept public service employment and become members of a parasitic caste.

II. My plan would cost a few dollars for administration. That is all. It would substantially increase the overall demand for labor in a controlled manner. It would preserve, or rather restore, the dignity of the individual and rescue the free enterprise system. It would greatly improve the quality of life in America.

III. All of us must adjust to a new set of facts:
  A. A way has been found to define and measure the labor content of economic activities.
  B. A book showing the labor content of U.S. industries has been published and will be updated, as neccessary.
  C. A method has been available to the Western Democracies since 1976 for establishing and maintaining a firm control over the levels of unemployment.
  D. The refusal of governments to accept and use this technique must be countered by the votes of the workers and all other voters to deny power to such governments.

I have kept this presentation brief, with the hope that I may have some good constructive criticism. Thank you.

THE UNEMPLOYMENT CRISIS AND POLICIES FOR ECONOMIC RECOVERY

WEDNESDAY, NOVEMBER 24, 1982

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, Wylie, and Kemp; and Senator Proxmire.

Also present: James K. Galbraith, executive director; Bruce R. Bartlett, deputy director; Richard F. Kaufman, assistant director-general counsel; Charles H. Bradford, assistant director; Betty Maddox, assistant director for administration; and Mark R. Policinski, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. The Joint Economic Committee will be in order for a hearing on monetary policy.

I might welcome back our Republican member, Representative Wylie, and Senator Proxmire will also be here. We are delighted to have you this morning.

I am happy and sad to be presiding over what will probably be my last occasion to voice my appreciation to Paul Volcker. You know how much I value our friendship and how splendid a public servant you are. You have served well for this country.

We meet today because our committee is disturbed about the conduct of the economic policy, monetary policy in particular, and its responsibility for the unemployment and recession that we are now in.

Interest rates have frequently been intolerably high in recent years. I recall two bouts of over 20 percent prime rates since January 1981. Interest rates have also been excessively volatile. They have jumped around much more after the great change in monetary policy in October 1979 than they did before.

Finally, the course of the monetary aggregates has been enough to drive a market watcher to distraction.

The chart shows [indicating] the growth ranges and actual behavior of M_1 in 1981 and 1982. The Reagan administration in its February 18, 1981, Program for Economic Recovery called for—growth rates of money and credit . . . steadily reduced from the 1980 levels to one-half those levels by 1986. The Federal Reserve agreed. But the actual result for M_1 was to be consistently under the target in 1981 and consistently over the target in 1982. It has been some years, in short, since the Federal Reserve has been able to throw its fast one over the plate.

FIVE PROPOSED REFORMS

In an effort to see whether Congress may not more adequately discharge its constitutional monetary responsibilities, I wrote Chairman Volcker a week ago proposing five reforms in Federal Reserve practice which, if adopted by the Federal Reserve, could help produce a healthy economy. Each one of these reforms could, I emphasized, be adopted by the Federal Reserve without any change in existing law.

With respect to the first reform, the chart at my right [indicating] is helpful. At the highest level are the national goals—maximum employment, production, and purchasing power, as stated in the 1946 Employment Act, and then the "full employment and production, price stability, 1978."

CONGRESS NEEDS FED FORECAST

Presently, the Federal Reserve in its monetary policy reports sets forth—not its estimates of what the level of GNP, employment, unemployment, inflation should be—the range of forecasts of the 12 individual members of the Federal Open Market Committee. This gives us no basis for comparing the objectives and goals of the Federal Reserve System with those of the President and the Congress.

We would not accept from the administration a set of estimates of these very important goals, which consisted of the separate guesses of President Reagan, Treasury Secretary Regan, Mr. Stockman, Mr. Baldrige, and several others. I have felt aggrieved that we have had to accept disparate views from the Fed.

We would be better served by a single composite forecast of the Federal Open Market Committee. I am sure, on a motion of the Chairman, they could get together on a single forecast so we can see the relationship between that forecast and the forecast of the President and the Congress. We could then, if necessary, adjust our own actions or adopt appropriate policy guidelines.

That is the first area.

A CREDIT TARGET

Second, we need a proper aggregate for credit, including the full array of lenders and borrowers, rather than restricting ourselves to bank credit as we do now.

I have set forth a number of things—credit by mortgage companies, et cetera—which seem to us to be part of this vital intermediate target and, indeed, one specifically set forth in the law. I would hope that the Fed would not continue to ignore nonbank credit, because it is so important.

LONG-TERM INTEREST RATES

The third element has to do with long term interest rates. These, as the schematic chart shows [indicating], are not quite an overall, overarching goal, like the top of the box, nor are they quite an intermediate target like monetary and credit aggregates are.

In fact, they partake of both, and earnestly do we plead with the Federal Reserve to give us what they think are a set of long term interest rates, particularly, which will be conducive to meeting your goals of maximum unemployment reduction and maximum purchasing power.

I notice the Treasury—yesterday, Treasury Secretary Donald Regan told a meeting with reporters that he expected interest rates to fall on a gradual basis if the Fed continues its current policies. If Regan can do it, why can't the Fed do it? We really ought to have this information. Had we had it in 1981, as you can see from the chart, the Open Market Committee's merciless squeezing of M_1 would have been more difficult. Had they been required to indicate the consequences of that monetary squeeze on long term interest rates, they would have had, in all candor, to predict the disastrous 18 percent mortgage rate which shortly ensued, the equally disastrous higher rates for corporate borrowing, and everything else.

Had they done that, they might have recoiled in horror from the monetary tightness which they were visiting upon us. Therefore, I renew my exhortation that the Fed not conceal from us that which the Treasury Secretary is glad to share with reporters at breakfast.

OPERATING PROCEDURES

Item 4 relates to the bottom box, operating procedures. There the Fed and, I think, this committee would agree that it should be flexible in its operatng procedures. There is no innate virtue in exclusively relying either on monetary reserves, as it does at the moment, or on interest rates, as it did a few years ago.

Why not take them and anything else that is relevant into account in operating procedures and focus on whichever works best?

CONSULTATION AND COORDINATION

Fifth, and last, Congress and the Fed need closer and fuller consultation and coordination. A more precise menu of policy information in the semiannual reports would help. Beyond this, we would hope that the Federal Reserve would report to the Congress any changes in its expectations for the big items—money, credit, interest rates, or the ultimate economic objectives.

Nothing in these points presumes to specify for all time the direction which the monetary policy should take or the strength with which it should be applied. That must be left to Congress and the Federal Reserve to agree upon in light of the facts of each situation.

[The letter referred to by Representative Reuss follows:]

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., November 17, 1982.

Hon. PAUL A. VOLCKER,
Chairman, Board of Governors,
Federal Reserve System, Washington, D.C.

DEAR MR. CHAIRMAN: This week, the Joint Economic Committee is concluding a series of hearings on how we can enhance coordination and cooperation between the separate branches of our government in order to improve the effectiveness of economic policy. Within that spirit, I would like to make a number of suggestions for strengthening the working relationship between Congress and the Federal

Reserve Board and the Federal Open Market Committee, which I hope we can discuss during your appearance before the Joint Economic Committee next Wednesday.

As you know, a number of bills have been introduced recently which would mandate changes in the procedures of the Federal Reserve and alter the nature of the dialog between the Fed and Congress on the conduct of monetary policy. I believe we could accomplish under existing law many of the improvements sought by Members of Congress in these bills.

The highest level of Federal Reserve decisionmaking concern is the national goals—"maximum employment, production, and purchasing power" under the Employment Act of 1946 and "full employment and production . . . (and) price stability" under the Full Employment and Balanced Growth (Humphrey-Hawkins) Act of 1978. Presently, the Federal Reserve in its February 20 and July 20 Monetary Policy Reports sets forth the range of forecasts of the 12 "individual members of the FOMC" with respect to the year's goals for employment, production, and purchasing power. We would be better served if the FOMC would present Congress with a single composite forecast of its members; if such a forecast differs from that of the President or of the Congress in its Budget Resolution, we in the Congress can then take account of such important differences between the Federal Reserve and the executive and legislative branches.

At the second level, constructive changes could also be made in the way in which the Federal Reserve reports on its intermediate targets—"the ranges . . . of the monetary and credit aggregates"—mandated by present law. Here I have two suggestions. First, present Congress with a single numerical target for each of the aggregates, along with the upper and lower boundaries that you think would be consistent with the goals delineated and set forth in the previous paragraph. Second, "credit aggregates" includes not just bank credit, which you currently target, but the entire range of credit by lenders other than banks as well. We should appreciate you including total credit in your report.

Long-term interest rates fall somewhere between the ultimate objectives of policy and the intermediate targets discussed in the previous two paragraphs. You should include in your report your best estimate of the array of long-term interest rates that is both consistent with your intermediate targets and conducive to achieving the ultimate objectives of policy. Long-term interest rates have a critical effect on our economic performance, and they should be part of the dialog between Congress and the Federal Reserve on monetary policy.

Finally, we should agree that the Federal Reserve should be more flexible in its operating procedures. The present exclusive focus on reserves as an operating procedure has produced significantly worse shortrun interest rate volatility. Why not an operating procedure which focuses either on reserves or short-term interest rates whichever currently works best?

In the event that the Federal Reserve's projections as to the monetary aggregates, credit aggregates or long-term interest rates should change after its February 20 or July 20 reporting dates, the Federal Reserve should promptly report such changes to the Congress.

Sincerely,

HENRY S. REUSS, *Chairman.*

Representative REUSS. Congressman Wylie.

OPENING STATEMENT OF REPRESENTATIVE WYLIE

Representative WYLIE. May I say that I feel very sad to contemplate the fact that this is your last meeting as chairman of the Joint Economic Committee. It has been a great honor and a magnificent pleasure for me to be associated with you, both as chairman of the Banking Committee and chairman of the Joint Economic Committee.

I know the association—in our association we have not always agreed on everything, but your leadership has been most beneficial to the Banking Committee and the Joint Economic Committee, Mr. Chairman.

Representative REUSS. I am most grateful.

Representative **Wylie**. Mr. Volcker, you certainly have one of the toughest jobs in Washington these days handling monetary policy. It is also one of the most important and one of the most difficult economic jobs in our government. I, for one, think you have done a commendable job over the last 2 years.

Inflation has been cut more than half, from the 12.4 percent in 1980 to around 5 percent now. The prime, which reached 21½ percent in December of 1980 is now at 11½ percent. That is a good sign. I say keep up the good work.

I think your policies, along with fiscal policies of the administration, are good. We have some problems, as we had in the late 1970's—we had a dizzy roller coaster at the time—but it seems to me you have things under control, and I look forward to your explaining what you have done, why you think what you have done is the right course. And what you have done has helped reduce inflation and has helped bring the interest rates lower.

Mr. Chairman, I welcome you to the committee here this morning and look forward to your testimony and the opportunity to ask some questions later on.

Thank you.

Representative **Reuss**. Senator Proxmire.

Senator **Proxmire**. Thank you, Mr. Chairman. I do not have any opening statement. I would like to join Representative Wylie.

I realize this is not your swan song; you will be back; but this may be the last time I have an opportunity to pay tribute to a remarkable man. You are a very able economist, outstanding Congressman.

One of the great things about Henry Reuss is his sense of humor and his ability to disagree without being disagreeable.

Henry and I have disagreed on many issues, as Henry has disagreed with the Chairman of the Federal Reserve Board. It has always been pleasant. We have always been able to work things out on a friendly, logical, civil basis.

I am sure I will see you in the coming session, but I want to take this opportunity formally, with the television cameras in front of us—what have you, maybe for the last time for the rest of the year with this receptive audience here—to tell you what a great job you have done.

You have done a great service in this Congress.

Representative **Reuss**. Thank you very much.

All right. Chairman Volcker, would you proceed with your statement, which we appreciate your giving to us. It will be received in full.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. **Volcker**. I would like to proceed by reading the statement, which is rather complicated, partly in light of the questions that you asked, Mr. Chairman, and I think it does direct itself in large part toward those questions.

I appreciate this opportunity to discuss with you today the current stance of monetary policy and some problems for the future. Before responding to certain questions directed to me about monetary policy in your letters of October 18 and November 17, Mr. Chairman, I should first emphasize that the basic thrust and goals of our policy are unchanged since I testified before the Congress on July 20. The precise means by which we move toward our goals must take account of all the stream of evidence we have on the behavior of—and distortions in—the various monetary aggregates, the economy, prices, interest rates, and the like. But we remain convinced that lasting recovery and growth must be sought in a framework of continuing progress toward price stability—and that the process of money and credit creation must remain appropriately restrained if we are to deal effectively with inflationary dangers.

For that reason, we must continue to set forth targets for growth in money and credit and to judge the provision of bank reserves—our most important operating instrument—in the light of the trend in the growth of these aggregates. This process necessarily involves continuing judgments about just what growth in those magnitudes is appropriate in the short and longer run, matters affected by institutional change as well as by more fundamental economic factors.

As you are aware, the current job of developing and implementing monetary policy has been complicated by regulatory decisions as well as by recent developments in the economy and in our financial markets. We have, as a consequence: (1) made some technical modifications in our operating procedures to cope with obvious distortions in some of the monetary data—particularly M_1, and (2) accommodated growth in the various M's at rates somewhat above the targeted ranges. The first of those decisions was essentially technical. The latter decision is entirely consistent with the view I expressed in testifying before the Banking Committees in July that the Federal Open Market Committee would tolerate "growth somewhat above the targeted ranges * * * for a time in circumstances in which it appeared that precautionary or liquidity motivations, during a period of economic uncertainty and turbulence, were leading to stronger than anticipated demands for money."

Unfortunately, the difficulties and complexities of the economic world in which we live do not permit us the luxury of describing policy in terms of a simple, unchanging numerical rule. For instance, the economic significance of any particular statistic we label money can change over time—partly because the statistical definition of money is itself arbitrary and the components of the money supply have differing degrees of use as a medium of exchange and liquidity. That doesn't make much difference in a relatively stable, economic, financial, and institutional environment, but, at times of rapid change, like the present, it can matter a great deal.

We also have to take account of varying lags—never known with precision—between actions today and their consequences later. We have to try to disentangle the temporary and cyclical from more persistent trends in relationships among different measures of money and inflation and economic activity. And we have to evaluate the significance of developments abroad as well as at home, as reflected in trade accounts and the exchange rate, and of strains in the financial structure itself.

As this suggests, the economic environment in which we set policy—or policy itself—cannot be condensed into a simple, one-dimensional statement. Perhaps the essence of the problem and our approach can be better captured by a few yes-but phrases.

(1) Yes, we have broken the inflationary momentum—but continuing vigilance and effort will be essential to continue progress toward price stability.

As you know, the broad price indices this year have been running at about one-half or less of the peak levels reached 2 or 3 years ago. As part of this disinflationary process, growth in worker compensation in nominal terms has declined to the 6 to 7 percent area—but that slower growth in nominal income has been consistent with higher real wages as inflation has moderated.

Price and cost trends in particular sectors of the economy are mixed—reflecting in part lags in the process of disinflation, the effects of long wage contracts, international and exchange rate developments, and the immediate effects of recession on some prices—most particularly commodities. But there is, it seems to me strong reason to believe that the progress toward price stability can be maintained—albeit at a slower rate—as the economy recovers. For a time, unemployment and excess capacity should restrain costs and prices and, of more lasting significance, productivity growth should improve from the poor performance of most recent years. Taken together, restraint on nominal wage increases and productivity growth should moderate the increase in unit labor costs, which account for about two-thirds of all costs. Real incomes can rise as inflation slows, paving the way for further progress toward stability.

To be sure, as the economy grows, some factors holding down prices over the past year or two will dissipate or be reversed. But large new price shocks in the energy or food areas appear unlikely in the foreseeable future, suggesting that a declining trend in the rise of unit labor costs should be the most fundamental factor defining the price trend.

That analysis would not hold, however, if excessive growth in money and credit over time came again to feed first the expectation, and then the reality, of renewed inflation. Too much has been invested in turning the inflationary momentum to lose sight of the necessity of carrying through. There are clear implications, as I will elaborate in a moment, for fiscal as well as monetary policy.

(2) Yes, exceptional demands for liquidity can reasonably be accommodated in a period of recession, high unemployment, and excess capacity—but guidelines for restrained money and credit growth remain relevant to insure against renewed inflation.

A variety of specific and general evidence strongly suggests that the desire to hold cash and other highly liquid assets, relative to income, has increased this year. Much of the more rapid increase in M_1 has been in interest-bearing NOW accounts, which did not exist a few years ago but which provide the basic elements of a savings, as well as transaction, account. With market interest rates falling, those accounts have been relatively more attractive on interest rate grounds alone, and they are a convenient means of storing liquidity at a time of economic and financial uncertainty. At the same time, the broader aggregates appear to reflect some of the same liquidity motivations, as well as the stronger savings growth in the wake of the tax cut.

Most broadly, we can now observe, over a period of more than a year, a distinct decline in velocity—that is, the relationship between the

GNP and monetary aggregates. The velocity decline for M_1, which is likely to amount to about 3 percent from the fourth quarter of 1981 to the fourth quarter of 1982, stands in sharp contrast to the average yearly rise in velocity of 3 to 4 percent over the past decade; it will be the first significant decline in velocity in about 30 years. M_2 and M_3 velocities—which had been relatively trendless earlier—have also declined significantly. While some tendency toward slower velocity is not unusual in the midst of recession, the magnitude and persistence of the movement in 1982 is indicative of a pronounced tendency to hold more liquid assets relative to current income. Without some accommodation of that preference, monetary policy at the present time would be substantially more restraining in its effect on the economy than intended when the targets for the various aggregates were originally set out earlier this year.

At the same time, policy must take into account the probability that the demands for liquidity will, in whole or in major part, prove temporary, and that an excessive rise in money or other liquid assets could feed inflationary forces later. Elements of judgment are inevitably involved in sorting out these considerations—judgments resting on analysis of the economy, interest rates, and other factors. But broad guidelines for assessing the appropriate growth on the basis of historical experience will surely remain relevant and appropriate.

In that connection, I must note the implications of the future Federal budgetary position. To put the point briefly, the prospect of huge continuing budgetary deficits, even as the economy recovers, carries with it the threat of either excessive liquidity creation and inflation in future years, or a crowding-out of other borrowers as monetary growth is restrained in the face of the Treasury financing needs, or a combination of both. The problem flowing from the future deficits are simply not amendable to solution by monetary policy. Moreover, the concern engendered in the marketplace works in the direction of higher interest rates today than would otherwise be the case, contrary to the needs of recovery. I know something of how difficult it is to achieve further budgetary savings, but I must emphasize again how important it is to see the deficit reduced as the economy recovers. The fact is those looming deficits are a major hazard in sustaining recovery.

(3) Yes, lower interest rates are critically important in supporting the economy and encouraging recovery—but we also want to be able to maintain lower interest rates over time.

Since early summer, short-term interest rates have generally declined by 5 to 6 percentage points, and mortgage and most other long-term rates have dropped by 3 to 4 percentage points. While consumer loan rates administered by banks and other financial institutions have lagged, they are also now moving lower. There are clear signs of a rise in home sales and building in response to these interest rate declines, and other sectors of the economy are benefiting as well.

We have also had experience in recent years of sharp increases in interest rates curtailing economic activity at times when recovery was incomplete and unemployment high. Sudden large fluctuations in interest rates contribute to other economic and financial distortions as well. And no doubt the fact that many interest rates remain historically high, relative to the current rate of inflation, reflects continuing skpeticism over prospects for carrying through the fight on inflation.

In this situation, the Federal Reserve has welcomed the declines in interest rates both because of the support they offer economic activity and because they seem to reflect a sense that the inflationary trend has changed. However, we do not believe that progress toward lower interest rates should—or for long in practice can—be forced at the expense of excessive credit and money creation. To attempt to do so would simply risk the revival of inflationary forces; renewed expectations of inflation would soon be reflected in the longer term credit markets, damaging prospects for the long-lasting expansion we all want.

Turning to your explicit questions, Mr. Chairman, against this general background, I believe most policymaking officials in the Federal Reserve share the general view that economic recovery will be evident throughout 1983, but at a moderate rate of speed—-probably slower than during previous postrecession years. Unambiguous evidence that the recovery is already underway is still absent, although encouraging signs are evident in some rise in housing, in the improved liquidity and wealth and reduced debt positions of consumers, and in surveys reporting that attitudes and orders may be stabilizing or improving. The Federal deficit, while fraught with danger for the future, is of course providing massive support for incomes at present.

What is crucially important—particularly in the light of the experience of recent years—is that we set the stage for an expansion that can be sustained over a long period, bringing with it strong gains in productivity and investment and lasting improvement in employment. I have already emphasized the importance of progress toward price stability to that outlook, and the evidence that, with disciplined monetary and fiscal policies, we can sustain that progress.

So far as the specific questions about monetary policy in your October 18 letter are concerned, we have not, as you know, set any new monetary targets for 1982. Current trends do indicate that the various M's will end the year above the upper end of the target ranges, probably by ½ to 1 percent for M_2 and M_3 and more for M_1 given the current distortions. Bank credit will be close to the midpoint of its range. As I indicated at the start, the overshoots, in the context of today's economic and financial conditions, are consistent with the approach stated in my July testimony.

No decision has been to change the tentative targets for 1983. That matter will, of course, be under intensive scrutiny over the next 2 months, and the targets will be announced in February.

For the time being, we are placing much less emphasis than usual on M_1. That decision was precipitated in early October entirely by the likelihood that the data would be grossly distorted in that month by the maturity of a large volume of all-savers certificates, part of the proceeds of which might be expected to, at least temporarily, be placed in checking accounts included in M_1.

In about 3 weeks, the introduction of a new ceilingless account at financial institutions—highly liquid and carrying significant transaction capabilities—is likely to distort further M_1 data. Judging by comments at the last Depository Institutions Deregulation Committee meeting, that account could rapidly be followed by a decision to approve a ceilingless account with full transaction capabilities. These new accounts could have a large, but quite unpredictable, influence on M_1 for a number of months ahead as funds are reallocated among various accounts. Moreover, the introduction of market-rate transaction accounts will very likely result in a different relationship and trend of M_1 relative to GNP over time. Increasing confidence in the stability of prices and a trend toward lower market interest rates might also affect the desire to hold money over time.

Obviously, some judgments on those matters will be necessary in setting a target for M_1 in 1983 and in deciding upon the degree of weight to be attached to changes in M_1 in our operations. Those problems should appropriately be described as technical rather than policy in the sense that we will need to continue to be concerned with the rate of growth over time of the monetary aggregates, including transactions balances.

The decisions taken in early October do point to greater emphasis on M_2 and (M_3) in planning the operational reserve path during this transitional period. The link between reserves and M_2 is looser and more uncertain than in the case of M_1, in large part because reserve requirements on accounts included in M_2, apart from transactions balances, are very low or nonexistent (Transactions balances are about 17 percent of M_2). Therefore once a reserve path is set, deviations of M_2 from a targeted growth range may not, more or less automatically, be reflected in a substantial change in pressures on bank reserve positions or in money markets as in the case with M_1. Consequently, "discretionary" judgments may be necessary more frequently in altering a reserve path than when that reserve path is focused more heavily on M_1. In that technical sense, the operational approach has necessarily been modified.

In sum, the broad framework of monetary targeting has been retained, but greater emphasis is for the time being placed on the broader aggregates. The specific operating technique that had been closely related to M_1 has, by force of circumstances, been conformed to that emphasis. Obviously, entirely apart from questions of economic doctrine and contending approaches to monetary control, so long as M_1 is subjected to strong institutional distortions our techniques must be adapted to take account of that fact.

An alternative operating approach suggested by some of supplying and withdrawing reserves with the intent of achieving a particular interest rate target would suffer from several fundamental defects.[1]

The body of theory or practices does not provide a sufficiently clear basis for relating the level of a particular interest rate to our ultimate objectives of growth and price stability.

The implication that the Federal Reserve could in fact achieve and maintain a particular level of relevant interest rates in a changing economic and financial environment is not warranted.

The very concept and measurement of a "real" interest rate, as called for in some proposals, is a matter of substantial ambiguity.

As a practical matter, attempts to target and fix interest rates would make more rigid and tend to politicize the entire process of monetary policy.

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[1] That was not, as sometimes mistakenly thought, the operating approach used prior to October 1979. Then, reserves were provided with the aim of achieving and maintaining a particular Federal funds rate *thought to be consistent with targets for the monetary aggregates*. The Federal funds rate was a *means* to achieving a monetary target and in principle was to be handled flexibly. In practice, among other difficulties, there appeared to be a reluctance to permit rates to vary rapidly enough to maintain control of the aggregates.

In current circumstances, with huge budget deficits looming, a requirement that the Federal Reserve set explicit interest rate targets is bound to be interpreted as inflationary, and the rekindling of inflationary expectations will work against our objective.

I realize the several legislative proposals addressed to targeting interest rates would, on their face, seem to call for interest rates as only one of several targets. But interest rates would certainly be the most obvious and sensitive target, and those targets would be difficult to change. Other evidence for a need to "tighten" or "ease" would be subordinated, if not ignored.

As we approach the target-setting process for 1983, our objectives will—indeed as required by law—continue to be quantified in terms of growth in relevant money and credit aggregates. We will have to decide how much weight to place on M_1 and other aggregates during a transitional period, assuming new accounts continue to distort the data. In reaching and implementing those decisions, the members of the FOMC necessarily rely upon their own analysis of the current and prospective course of business activity; the interrelationships among the aggregates, economic activity, and interest rates; and the implications of monetary growth for inflation. In other words, the process is not a simple mechanical one, and it seems to me capable of incorporating—within a general framework of monetary discipline—the elements of needed flexibility. We will also, as part of that process, review whether technical adjustments in procedures for establishing and changing the reserve paths are appropriate. I will be reporting our conclusions to the Congress in February.

Mr. Chairman, you have suggested that our monetary targets might reasonably be specified as a single number, with a range above and below. At times we have debated within the FOMC the wisdom of such an approach (or setting forth a single target number without a range). My own feeling has been, and remains, that a single number, with or without a range, would convey a specious sense of precision, with the result of greater pressure to meet a more or less arbitrary number to maintain "credibility," even if developments during the year tend to indicate some element of flexibility is appropriate in pursuit of the targets.

To me, our present practice of setting forth a range is preferable. Where appropriate, we can and should suggest the probability of being in the upper or lower portion of the range, or suggest what conditions could evolve in which something other than the midpoints (or even an over or undershoot) would be appropriate. That approach seems to me to provide more information—and more realism—than a single number and is broadly consistent with present practice.

For similar reasons, I believe we need to measure and target a variety of aggregates because, in a swiftly changing economic environment, any single target can be misleading. In that connection, I believe an indication of total credit flows broadly consistent with the monetary targets could be helpful. As you know, we now provide such estimates for bank credit alone.

Given the limits of forecasting and analysis, and the volatility of the data, I would question the usefulness of further sectoral estimates. Even with respect to total credit flows, there is considerable looseness in relationships to economic activity for periods as long as a year—and still more for shorter periods. The theoretical framework relating credit flows to other variables such as the GNP or inflation is less fully developed than in the case of monetary aggregates, and credit flows are less directly amenable to control. The enormous flows across international borders pose large conceptual and statistical problems. Our credit data are typically less complete and up to date than monetary data.

However, so long as those difficulties and limitations are recognized—and some of them are relevant with respect to the monetary aggregates as well—I share the view that analysis of credit flows can contribute to policy formulation. To assist in that process, I will propose to the FOMC that estimates of the expected behavior of a broad credit aggregate be set forth alongside the monetary targets in our next report.

I do strongly resist the idea of the Federal Reserve as an institution forecasting interest rates. No institution or individual is capable of judging accurately the myriad of forces working on market interest rates over time. Expectational elements play a strong role—fundamentally expectations about the course of economic activity and inflation, but also, in the short run, expectations of Federal Reserve action. We could not escape the fact that a central bank forecast of interest rates would be itself a market factor. To some degree, therefore, in looking to interest rates and other market developments for information bearing on our policy decisions, we would be looking into a mirror. Moreover, the temptation would always be present to breach the thin line between a forecast and a desire or policy intention, with the result that operational policy decisions could be distorted.

While it seems to me inappropriate for a central bank to regularly forecast interest rates, analysis of key factors influencing credit conditions and prices can be helpful at times. On occasion, we have provided such analysis in the past. My concern about the outlook for fiscal policy is rooted in major part in such analysis because the direction of impact on interest rates seems to me unambiguous. I have also, on a number of occasions, indicated that the recent and even current level of interest rates appears extraordinarily high, provided, as I believe, we continue to make progress on the inflation front. Perhaps, in our semiannual reporting, we can more explicitly call attention to major factors likely to influence short- or long-term interest rates and the significance for various sectors of the economy. But I do not believe interest rate forecasting would be desirable or long sustainable, and would in fact be damaging to the policy process.

Finally, Mr. Chairman, you have requested a single composite forecast of the major economic variable by FOMC members. As you are well aware, our present practice is to set forth a range of forecasts of individual FOMC members of the nominal and real GNP, prices, and unemployment. The fact is we have no single Federal Reserve forecast, and there is no mechanism, within a committee or board structure, to force agreement on such a forecast by individual members bringing different views, typically backed by separate staff analysis, to the table. A simple average—possibly supported by no one—seems to me artificial. The process of attempting to force a consensus would certainly dilute the product.

I would put the point positively. A range of forecasts by individual FOMC members more accurately conveys the range of uncertainty and contingencies that must surround any forecast. The seeming neatness and coherence of a single forecast too often obscures the reality that a variety of outcomes is possible; the very essence of the policy problem is to assess risks and probabilities—what can go wrong as well as what can go right. A point forecast would likely be treated more reverently than it would deserve, and could even distort policy judgments in misguided efforts to hit a forecast.

I can understand your concern that a range of forecasts may be misleading if strongly influenced by outlying opinions rather than reflecting a more even dispersion of views. For that reason, I would be glad to explore with the Open Market Committee a procedure by which we indicated the central tendency of members' views—assuming such a central tendency exists—as well as indicating the range of opinions. Conversely, if the forecasts were evenly distributed within the range, we could so indicate. I believe that approach would meet the objectives you seek in a realistic and helpful manner.

In concluding this already long testimony, let me say that we share the common goals of achieving, in the words of the Employment Act of 1946 and the Humphrey Hawkins Act of 1978, "Maximum employment, production, and purchasing power" and "full employment * * * (and) reasonable price stability." Those objectives have eluded us for too many years. We meet again today in particularly difficult circumstances, and there is a sense of frustrating and uncertainty among many.

But I also happen to believe we have come a long way toward laying the base for economic growth and stability; economic recovery should characterize 1983, and that recovery can mark the beginning of a long period of stable growth.

Obviously there are obstacles—interest rates are still too high; inflation is down but not out; there are strains in our financial system; we face budget deficits that are far too high; we are tempted to turn inwards or backwards for quick solutions that ultimately cannot work. But it is also plainly within our capacity to deal with those threats—provided only that we have a strong base of understanding among us, that we resolve to act where action is necessary, and that we have the patience and wisdom to refrain from actions that can only be destructive.

You are leaving the Congress after 28 years, Mr. Chairman. Through that time, you have consistently provided constructive leadership to the effort to raise the level of economic discussion in general—and of the dialog between the Congress and the Federal Reserve in particular. I happen to believe strongly in the independence that the Congress has provided the Federal Reserve through the years—but also in the need for close and continuing communication with the Congress and the administration. I presume that this is the last time I will appear before you personally in this forum, but the dialog will continue to benefit from your efforts, your initiative, and your sense of commitment in more ways than you may realize.

Representative REUSS. Thank you so much.

I want to thank you, Chairman Volcker, for your responsive reply this morning in your statement to the five points I raised in my November 17 letter which I reiterated in my opening statement this morning.

On many of the points, you have, indeed, been very forthcoming. On others, I'm, at the moment, not entirely pleased. And that may simply be my difficulties with communication, which maybe we can straighten out.

FIVE POINTS REVISITED

So, let's take the five points. The first one was our point that we'd appreciate in Congress from the Fed—as we get from the executive branch and from ourselves—a composite forecast of employment, production, and purchasing power. There are the same vulcanizing techniques in the other branches, but somehow the 535 Senators and Congressmen have the budget resolution. I take heart from the fact that you say—and I'm quoting from your statement—that you "would be glad to explore with the open market committee a procedure by which we indicate the central tendencies of members' views, assuming such tendencies exist. Conversely, if the forecast were evenly distributed, we could so indicate."

That is great progress. And let me just suggest that in your conversations with your colleagues on the Open Market Committee, you see whether they would agree, after full discussion and after giving the range of their individual views, that you do try what the Executive and Congress tries; namely, to get a sense of a meeting.

If the Open Market Committee, by a vote of 7 to 5, were to estimate 4 percent growth, 5 percent inflation, 6 percent unemployment, so be it. And if there are extremes at either end of a range, fine. This committee is long on dissenting views, additional views, supplementary views. Those could be added.

Can we try to reach a compromise along those lines? I don't think I've said anything very different from what you said in your statement this morning.

Mr. VOLCKER. I'm not sure, whether we can; it depends on how it is interpreted. I can discuss it with members of the committee.

I generally feel that the kind of "solution," if that is the right word, that I mentioned in my statement is, broadly, the right one. You referred to the fact, for instance, that Congress has to come up with a single-point estimate in setting the budget; that is a fact of life, because you have got to present a budget in numbers.

I would say to you that I think while, as a practical matter, you have to come up with a single number in presenting the budget—simply because it is too hard to handle if you present a variety of possibilities—that does not, on balance, contribute to the realism of the economic dialog because a lot of attention is put upon that single number, as if it were graven in stone. But indeed, there is a range of uncertainty around it, to the extent that the budgetary outcome, for instance, fluctuates simply because the employment or the inflation estimate was wrong, it has different policy significance than otherwise.

While you have to set a single figure in the budgetary process, as a practical matter, what I would urge you to consider is that, in terms of considering economic policy, a range—with its sense of uncertainty as a best guess or a central tendency in my words— gives you what you are really looking for, and gives it a way that assists the policy process and does not damage it.

Representative **Reuss.** I like what you have just said so much. It is perfect for me except for your emphasis on so-called central tendency as a corollary suggestion, that where you have extremes, the sublime and the ridiculous on either end, you're going to back off from getting a sense of the meeting.

Why can't you give us a central tendency, however, scattered it is, and also give them in ranges?

COMPROMISE AGREED TO ON FORECASTS

Mr. **Volcker.** What I am implying is that when we give you a central tendency, we will give it to you however scattered it is.

I can imagine situations where each person's forecast is a quarter of a percent different, exactly evenly dispersed. We would have to tell you everybody's forecast is evenly dispersed in this range. There is an arithmetic average, but it doesn't mean much.

Representative **Reuss.** Enough said by me. You seem to be doing fine.

What you are suggesting is that you give us both, give us the central point and then tell us as much as you care to, the more the better, about the values, the individual views of President Smith of the Dallas bank, and President Jones of the Atlanta bank.

Mr. **Volcker.** I don't think I want to get into any President's views.

TOTAL CREDIT TARGET AGREED TO

Representative **Reuss.** Let's go to point 2.

There I am delighted that you agree with our point, that just giving us bank credit can be improved upon, and you are willing to give us the full range of credit. Agreed, statistics are not all that perfect. In my statement, I gave a number of sources. I thank you for agreeing.

Mr. **Volcker.** For purposes of clarity, by the full range, my intention would be to give you the total. We could continue with a bank credit section, but we would not attempt to give you separate figures for insurance companies or money market funds.

Representative **Reuss.** Total credit, bank, and nonbank, absolutely.

LONG-TERM INTEREST RATES: DIFFERENCES REMAIN

Point 3, I guess represents the greatest difficulty between us—in part, I think—because of my own maladroit presentation in asking that the Federal Reserve consider the consequences of its intermediate targets on the vital goal of long-term interest rates.

I am not suggesting that you target interest rates. I am not suggesting that you forecast interest rates. I am suggesting that you set forth the consequences of the given monetary policy adopted in any one time by the Federal Reserve on long-term interest rates, because they are, indeed, important to this country and to the great goals of employment, production, and purchasing power.

I point out again that Treasury Secretary Regan yesterday, at the breakfast meeting said: "I expect interest rates to fall on a gradual basis if the Fed continues its current policies." Who knows better than the Fed what the current policies are?

Why can't you indicate what effect you believe those policies will have on long-term interest rates, taking into account your assumptions on fiscal policy, on foreign trade and investment, on exogenous shocks and inflation, and all the variables that you have to use?

That's all I'm asking.

Wouldn't you discuss with your Open Market Committee and colleagues whether it would not only be possible but constructive and helpful to Congress to do that?

Mr. VOLCKER. We may be dealing with a thin line, but I think it is an extremely important line, Mr. Chairman. I understood that you were not suggesting targeting, but I did understand that you were suggesting a forecast.

If you want a general forecast, I give these all the time, in a sense, about the effect of monetary policy on interest rates. Monetary policy is directed broadly toward restraining of inflation and restoration of price stability. There is no doubt in my mind that in time that is fundamental to bringing down interest rates, and that policy would be reflected in a much lower, long-term interest rate over a period of time.

I have said that on numerous occasions. I will say it again.

I think that analysis is shared by members of the commitee. That is quite different from saying, "In 1983, we expect the long-term interest rates to go down in the early part of the year and level off," or vice versa. We give a general direction of influence that we think is apparent over time.

I can make similar comments about fiscal policy, but I do not think it is wise for us to get into the business of trying to outguess the market about the effect of the near-term direction of interest rates.

Representative REUSS. I hope you will discuss it with your colleagues, the precise long-term interest rate emphasis that our colloquy has indicated is in our minds.

May I say that had I been a member of the Open Market Committee—God forbid—in 1981, when that redline indicated actual creation of new M_1, if we had envisioned that undertarget monetary policy was going to result in 18 percent mortgage interest rates and 15 percent long-term and corporate bond rates, we would have, perhaps, thought twice as to whether we did not want to keep M_1 a little more ebullient. I hope in your discussion with your colleagues you will at least present the point I am making.

AGREEMENT ON FLEXIBLE OPERATING PROCEDURES AND ACCOUNTABILITY

I pass on now to the last two points on which I believe—though I want you to confirm—we are in good accord. Proposition No. 4 was that the Federal Reserve ought to feel free to be flexible in its choice of operating procedures. I personally have no quarrel with your present operating procedures, which center upon reserves. Earlier, the emphasis was on the funds rate. All we say here is that the Federal Reserve should feel free to exercise its sound discretion as to what is a good operating procedure, and should not feel inundated by any assumed iron maiden in Congress. How about that?

Mr. **Volcker**. I think, as you worded that, I can agree emphatically. I certainly think we should use whatever operating technique appears to us to be most suitable to the circumstances.

I am not quite sure what you mean by "operating procedure." We do have a law which says: Set out the aggregate targets for the aggregates; and we agree with that. We need that kind of discipline and guidepost and signpost for our actions in setting those targets. To exercise judgment, we have got to look at a lot of factors. As to choosing what I think of as the operating techniques—how to proceed on a day-to-day basis—we certainly have to adapt that to what the circumstances call for.

Representative **Reuss**. You would agree—here I am saying that Congress is telling you to follow your own good instincts as to operating procedures. I cannot imagine your objecting to that. Now that I hear you don't, that is fine.

The fifth and last point we made is one, again, that I believe the Open Market Committee would welcome. That is, when you make a change in your targets, or your estimates of the ultimate goals and policies, inform the Congress. As it is now, you do inform people like business councils down at Hot Springs, and that's fine——

[Laughter.]

Representative **Reuss** [continuing]. But let us in on the secret. [Laughter.]

That surely would not be taken amiss by your colleagues, would it?

Mr. **Volcker**. I don't think I addressed the point directly. This gets into the fine line between what is the kind of change that should properly demand a congressional hearing, and what can be handled by some other kind of an announcement.

I did not interpret the change that we made in October with respect to M1—knowing in October that that distortion was coming up in M1, not knowing it earlier—nor the fact that for the time being we would follow an above-target growth in the broader end of the range, as being outside the framework that I discussed with the Congress in July.

Representative **Reuss**. Since you chose to say that you kept your target, you do not owe us a report under the regimen I am suggesting. We could argue it at another time—where you could have said: Look, we are changing our targets.

Mr. **Volcker**. If we decided that we faced a basic change in trend, let's say, of these targets, that we wanted to change them, that we would change them between the semiannual reporting dates, then I think what you suggest would be the procedure followed.

Representative **Reuss**. My time is expired, but let me say I think this has been a valuable colloquy.

FOMC WILL DISCUSS THESE ISSUES IN DECEMBER

Are your mind and my mind in synchronization that you will bring up at the Open Market Committee meeting, which will be held, I believe, in a few weeks, various points discussed with this committee today? To what extent do we have a meeting of the minds? I am very hopeful that we do.

Mr. **Volcker.** I can bring those points up at that meeting, as I indicated in my statement I would do. They are operationally relevant, I suppose, but perhaps not for the December meeting. I can bring them up in the January or early February meeting, prior to the regular report that we bring to the Congress.

Representative **Reuss.** Because they do affect relationships between the Congress and the Fed, I would hope that you would produce a sense of the meeting as soon as possible. Indeed, if you do it by telephone, before late December, that would be appreciated.

Mr. **Volcker.** I can discuss these points with the committee. We would not have a new forecast, we would not have new targets, we would not have a credit target, in December.

Representative **Reuss.** Agreed. What I would expect and hope for is some agreement on the principles.

Senator Proxmire.

Senator **Proxmire.** Thank you, Mr. Chairman.

PSYCHOLOGY OF UNEMPLOYMENT IS DEPRESSING THE ECONOMY

Mr. Volcker, toward the end of your statement, you say the following: Obviously there are obstacles in the way of stimulating growth of the economy, you say; interest rates are still too high; inflation is down but not out; there are strains in our financial system; we face budget deficits. We are tempted to turn inwards or backwards for quick solutions that ultimately cannot work.

Isn't one of the biggest obstacles the one that you have not stated here, and that is the feeling on the part of millions of Americans that they may be out of work tomorrow? Recognition that we have 11½ million people out of work right now, that the unemployment has been increasing, and shouldn't we face that obstacle and try to adopt policies or state polices that clearly and conspicuously overcome it?

For instance, there is nothing to indicate that it's the responsibility of monetary policy to put people back to work in home building. In the automobile area, where interest rates are also an enormously important factor—farm implements, and so forth, small business generally—interest rates, in the view, certainly, of millions of Americans, have been the element that has crucified them. Shouldn't we in a statement from the Chairman of the Federal Reserve have a recognition that this psychological feeling on the part of people, which is certainly based on hard and bitter experience, say something that monetary policy has the responsibility to meet?

Mr. **Volcker.** Let me say, Senator, that perhaps my statement is not direct enough, but I do on a number of occasions refer to a sense of uncertainty, a sense of frustration. I do think that that affects economic behavior, and I refer to it explicitly in connection with the desire for liquidity, to hold cash, and I point out that because of that fact—that is apart from institutional technicalities—we are willing to run above target; we feel that particular response of people to the very concerns that you mention leads to behavior that, in a sense, has to be offset or partially offset by monetary policy. I certainly believe that the factor you mentioned is a factor in the business situation.

Looking at it as a policy problem, apart from the excessively technical points I make, how do we indicate what you suggest? We have had interest rates really very sharply lower since summer, down from very high levels, to be sure. I think we see the effects of that in the housing area particularly. That is where the signs are the clearest, and we seem to have an upturn there—from a low level, indeed but still a reasonably well established uptrend in the housing area.

Interest rates in the consumer credit area, as I mentioned in the statement, are slowly coming down, and this has affected the automobile industry.

We come back to the whole dilemma that we face, the whole policy problem. Yes; we want to deal with the problems that you mentioned. We have to do that in a way that does not set off either the concern or the reality of inflation, after so much progress has been made there. I would fear that if that happened, you would not get the result that you want and that I want. The uncertainty would arise in a different direction. It would not be dissipated. It would be contrary to economic recovery.

Senator PROXMIRE. My difficulty is I think that most Americans, when we are talking about M_1, M_2, the changes in M_1 and M_2, and so forth—it is gobbledygook. If we explain the shift in monetary policy based on the fact that M_1 is not quite the same factor it was, rather than on a plain, simple recognition that the economy is in trouble and the people are not out of work, that we have to do something to provide for better utilization of capacity. One-third of our capacity now is idle. It is a situation where we need stimulus.

What concerns me is that the stimulus is going to come whether you like it or not, as long as we have this kind of a situation from fiscal policy. The President has proposed, as we all know, moving the July 1983 income tax cut up to January 1, as his kind of stimulus. And he also proposed a jobs program; he does not like to call it that, but it is a jobs program, to increase the gasoline tax. Members of Congress proposed other jobs programs. That will come on unless we have a clear definition and expression of the monetary policy as a better way to go, and I certainly think it is.

PROPOSAL TO ACCELERATE JULY 1, 1983, TAX CUT

Now, let me ask you: You said on many occasions that your job would be a lot easier if fiscal policy were tight. What is your opinion of the proposal floating around the White House to move the July 1983 income tax cut forward to January?

Mr. VOLCKER. I have some concern about it, because I think it obviously makes life at least marginally more difficult from the monetary policy side that you are referring to.

It depends upon the context, I suppose, in which it came. If there were some speedup of that tax cut and at the same time vigorous action were taken to cut down the future deficits out there in 1984 and 1985, where I think the problem is, then maybe you have got a balance.

But I do not think signals that the deficit is going to get worse and not better are what we need now. If that were going to be considered at all, I would hope that it would be considered as part of a package where action is also taken in dealing with the deficit in those out years, where the risks to continuing recovery seem to me very great. At the moment, we already have a very large deficit, of course. You can argue, as I mentioned in the statement, that that is a support to economic activity at the moment, but let's not forget about the deficit out there in the future.

Senator PROXMIRE. You are saying that as far as you are concerned it would be acceptable fiscal policy, that you would not object to if we did move the tax cut up to January 1, and at the same time took action, for example, in terms of procurement, which would have little effect in 1983 but can have a very big effect in 1984, 1985, and 1986, to reduce the deficit at that time? I am not asking you to take a position on procurement, but as an example.

Mr. VOLCKER. I think if sufficiently strong actions were taken—I do not know just how I would quantify those—but if sufficiently strong actions were taken in a number of areas that affected not fiscal 1983, but fiscal 1984, fiscal 1985, and the years beyond, a large part of my concern would be dissipated.

I do not know whether that is reasonable and feasible. I obviously have a concern about it as it stands.

EFFECT OF NEW DEPOSIT ACCOUNTS

Senator PROXMIRE. You mentioned a new deposit account. That will take effect on December 15. You said at the DIDC meeting that the new instrument would destroy M_1. Your statement today carries the same implication, and goes further to say that M_2 is too loose a guide for monetary policy.

Now, the distinction between transaction balances, M_1 savings balances, M_2, and M_3 is probably gone forever, as you imply. What does that mean for monetary policy? Where are you going to conduct monetary policy, given the changes in financial instruments, and the inexactness of M_1 and M_2?

Mr. VOLCKER. If I recall correctly, I made that statement in response to a question during discussion of a further new instrument that would have full transactions capability. Certainly the instrument already approved will have an important distorting influence for a period of time.

But I think I made that comment in reference to the additional instrument that would have full transactions capabilities—at least I had that in mind. You can imagine a situation where, in practice—and that is what I was imagining when I said that—to a substantial degree, we could not statistically distinguish between a transactions balance and a basically savings-type deposit.

If you are in that position, you have got great difficulties with M_1, because you have not got a statistic that reflects the transactions nature of the instrument. And I think you are then forced to put much more weight—and continue to put much more weight—on the broader monetary aggregates, and, to some extent, as we discussed earlier, on the credit aggregates—if that is the way it goes, institutionally.

I regret that from a monetary standpoint, because I think there is certainly a very significant body of analysis over the years that says that there is something special about a transactions balance, if you can measure it. I was facing the possibility you could not measure it.

FOREIGN LOANS

Senator PROXMIRE. You and the Comptroller of the Currency and the FDIC are responsible for the soundness of the U.S. banking system. The public looks to the Fed to make sure that the banking industry engages in sound practices. It is no secret that the larger banks have a large volume of nongrowing assets. We are all aware of the problem with loans to Mexico, Argentina, Poland, other countries that are delinquent in paying their loans. Under the circumstances, it seems essential that banks not send good money after bad, not endanger further their capital position by making more loans to shaky foreign countries.

The reason I am making the statement is, I was surprised to read your remarks of November 16 in the New England Council. You told the Council that if a foreign country has agreed on an economic program with the International Monetary Fund, quote:

> Where new loans facilitate the adjustment process, enabling a country to strengthen its economy and service its international debt in an orderly manner, new credit should not be subject to supervisory criticism.

I have two problems with that statement. First, despite the caveats you attach, you seem to be saying that the Federal banking supervisor should look the other way while U.S. banks go deeper and deeper in risk in lending abroad. And second, there is obviously a double standard at work here.

I had not heard you to encourage banks to lend to American farmers, home builders, or other small businesses. Are you applying a looser supervisory standard to bank loans to foreigners than to loans for Americans?

Mr. VOLCKER. No, sir; I do not think so. Let me explain the statement. Maybe we do have a disagreement.

The issue I was addressing was not past practices in this respect, although I think what has happened in this area obviously raises questions with the banks. It raises questions with the supervisory authorities, about what changes we might make in the future in terms of supervisory approaches toward particular concentrations of credit. That is a relevant question, and one that we will be addressing. We have addressed it in the past, and we will continue to address it in the future and try to learn from experience.

The sentence you quote was directed toward a rather more immediate problem. A number of countries that are obviously having debt servicing difficulties. They have had large balance-to-payment deficits, which are related to the buildup in loans. They are engaged in very difficult and aggressive adjustment programs which are fundamental to a restoration of their health, fundamental to their capacity to service that debt in the future. It also happens to be true that a country in that position cannot overnight go from a large deficit and a very heavy dependence on external financing for repaying bank loans, to absolute current account or overall balance-of-payments equilibrium.

It takes time. Since there is a transitional period, and assuming the caveats are an absolute part of that statement and not separate from it, then if a country is undertaking an adjustment program—very difficult, but ultimately very healthy—a program that is going to strengthen its economy and its capacity to service its debt, I do not think it is a matter for supervisory criticism for the banks to provide additional credit to make that program working and viable.

The alternative is an inability of those countries to service the debt, and it will make the loans bad instead of making them good.

Senator PROXMIRE. What would that do to the banks' position?

Mr. VOLCKER. When you get the strong adjustment programs, what you will find in every one of these cases is that the amount of new credit that is necessary is sharply reduced from what the banks have been providing in recent years.

You will find that they are able to provide this additional bank credit consistent with a reduction of their exposure relative to assets or capital. It is not going to be a dramatic reduction in the short run, but what you will end up with is, typically, some reduction in their relative exposure, and a much stronger base—if these programs are successful—for servicing those loans. We will be in a sounder position, not in a weaker position.

You refer to other sectors of the economy. Banks have a self-interest, obviously, in dealing with other distressed borrowers. If they are engaged in a program of writing a company or an individual some additional credit, that may be important; it is quite different from just throwing, as you say—good money after bad.

The adjustment program is absolutely essential to that process. We have countries that are coming to the IMF, getting international endorsement of their adjustment programs. We are, in effect, saying collectively, officially, through the IMF, that this country is doing the right thing; that it is getting its economy, its finances, back on a sound footing. Some credit is required during that period, but sharply reduced credit from the rate of growth in the past.

Representative REUSS. Representative Wylie.

Representative WYLIE. Thank you, Mr. Chairman.

Mr. Volcker, may I say that I am very encouraged by the exchange between you and Chairman Reuss a little earlier. I had sensed earlier this morning that there might be not quite as much of an agreement between the two of you, as far as your judgment is concerned, and use of it. To me, that was encouraging to see.

NEED FOR FLEXIBLE MONETARY TARGETS

Mr. Volcker, you suggest that monetary policy not be guided by a simple numerical rule. You suggest that setting targets for growth of money and credit is a matter of judgment.

Could you elaborate on that a little bit? What variables do you consider particularly significant in that connection?

Mr. VOLCKER. Let me take as an example what has happened in the last 6 months or so. We have had a situation in which recovery has obviously been slower to come about than we and most others anticipated 6 months ago, 12 months ago. We have had some strains on the financial system that added to the kinds of concerns, that Senator Proxmire mentioned.

We had, for a while, interest rates seemingly extraordinarily high relative to past relationships between important variables, which suggested a desire for liquidity, among other things. We have had, increasingly—while these figures jump around from quarter to quarter or over a period of quarters, reflecting technical factors—a decline in velocity, the overall relationship between money and economic activity.

That does not bother you for one quarter; maybe it is understandable for two quarters and you expect when that happens that it will bounce back, and you must be cautious about it bouncing back. But when it persists, you have to take it as a further indication that something is going on which for a significant period of time is changing the relationship between M1, M2, the economy, and inflation.

As you arrive at that conclusion in this particular instance, you say:

> We will be more tolerant of an overshoot, because the relationships that we were counting on have been changing demonstrably in the course of the year.

You also have to exercise judgment in the opposite direction. Based upon a lot of history, your first assumption may be that if velocity changes it may bounce back, so you do not want to overdo it. You have to balance that against the risk that looking ahead 6 months or whatever you will find out that velocity is moving strongly in the other direction, and you may have too much liquidity in the system. I don't know how to approach that problem other than with judgment.

Representative WYLIE. I want to follow up on that. I think that is a very important point you are making. You said that in 1982, this year, M_1 velocity has now leveled. So it will fall for the first time in 30 years or so.

Mr. VOLCKER. I think there was a decline in 1 year in the last 30 years of one-tenth of 1 percent.

Representative WYLIE. I am told in the past, in the years immediately following the median or low, we had unusually big increases; for example, 1954. M_1 velocity fell by 1½ percent, and then rose in 1955 by 5.7 percent. In 1958, velocity growth was zero and in 1959 it was 6.3 percent.

Why should we think that at this time it would be different? Why should 1983 see a decrease in velocity?

Mr. VOLCKER. You are looking at a different velocity figure than what I have before me. My annual figures are measured from fourth quarter to fourth quarter and on that basis there are no declines in velocity during the 1970's.

Representative WYLIE. For an annual period.

Mr. VOLCKER. The point that you are making is similar to the point I made at the end of my previous answer. You get a lot of bouncing around in velocity in the short run, and you get some tendency for velocity to be slower than it otherwise would be; it does not actually drop during a recession period on an annual basis for a long while, but you have a slower growth during recession periods. The normal expectation is that it will bounce back during a recovery period and be exceptionally fast during a recovery period.

That may happen this time and, in fact, I would not expect this velocity decline to continue. I would expect, as the economy recovers, velocity would go back. We are talking about a matter of degree. We have a velocity change here that is larger than any we have had in the postwar period, I think. It is the first significant one for 30 years.

Yes; I would expect some movement back in the other direction. We have to be cautious about that. We have to prepare for it. There may also be something else going on here that says we cannot simply afford to ride through this period without any allowance for what we have observed going on in velocity for five quarters now.

TAX POLICY AND DEFICITS

Representative WYLIE. I want to get on to a question that Senator Proxmire asked a little earlier. I think your judgment is important, and I want to understand your position on this.

Senator Proxmire asked if you favor the speeding up of the tax cut from July 1 to January 1, and as I understand, you said that you would oppose that unless spending could be reduced accordingly.

Mr. VOLCKER. I would make a distinction in timing. What I would like to see is important action—I would prefer to see it on the spending side, but if it has to be taken on the revenue side, all right—dealing with what I believe is the structural deficits, which is going to exist even when the economy recovers; even if we go back to something we can call full employment, we are going to have a big deficit.

What worries me is whether that deficit is, in fact, consistent with sustaining a recovery, so if there were important actions taken to deal with that problem—not today, in terms of current expenditures—but to deal with the problem that is inherent in the budget in 1984 or 1985 or 1986, then I do not think speeding up a tax cut by 6 months is going to complicate our lives in terms of expectations, in terms of complicating the budgetary problem. I am afraid it would complicate matters if it were just taken as an action that, in a sense, moves toward bigger deficits, I am afraid that would be the interpretation.

Representative WYLIE. I am somewhat worried about the short-term revenue reduction which might result from a speedup of the tax cut. What would be your position about deferring the tax cut?

Mr. VOLCKER. I would be inclined to leave things as they stand now, so far as the tax cut is concerned, but I would also have to add promptly that it leaves you in an unsatisfactory budget position. So leaving that tax cut where it is, is not at all inconsistent with my feeling that you still need strong action for 1984 and 1985 to deal with the structural deficit.

I would hope that action would——

VOLCKER COMMENTS ON REPUBLICAN INTEREST TARGETING PLAN

Representative WYLIE. Mr. Volcker, while you are here and while I have the opportunity, I would like to refer to a bill which was introduced called H.R. 7218, if I may. The reason I would like to bring it up here is because it does have distinguished authors, famous and distinguished authors.

It says on page 3 of this bill that—if we could go back a little earlier, the bill says: "It is the purpose of this act to return predictability and stability to financial markets and provide lower real rates of interest." And it says: "Targets for short-term interest rates are achieved on a monthly basis."

What is your position with respect to that bill? The so-called target of real interest rates on a monthly basis.

Mr. VOLCKER. I attempted to address it in the middle of my statement. I did not recall it was literally targeting real interest rates on a monthly basis. I have the problem that I do not know what a real interest rate is.

Representative WYLIE. The principal authors of the bill said on page 3, "short-term interest rates are achieved," and the word "monthly"—it says, "on a monthly basis."

Mr. VOLCKER. I did not recall that, but that makes it worse, from my standpoint. What is a real interest rate? We use the term; I use the term, usually with a footnote, in my mind.

You have some conception that it is the relationship between interest rates and the rate of inflation. But, expressed a little more precisely, what you really have in mind is interest rates against the expected rate of inflation during the time that the interest rate is relevant.

We have a lot of current inflation figures, and they bounce around even more than the money supply from month to month. What inflation rate are you comparing, let's say, a 1-month interest rate to? Last month's CPI? This month's CPI? The CPI averaged over 6 months? Then you get into a little longer term perspective.

Maybe you really are interested in CPI, assuming the CPI was a good index—which it is not, always—over the next 6 months. But you don't know; you may get a different story from the wholesale price index. It may be affected by temporary factors that nobody takes into account.

You are not dealing with a figure that anybody can identify; maybe more accurately, if you sit a dozen people down, they will have a dozen identifications of what the real interest rate is at any particular point in time.

I think it has just that technical problem. I would repeat, given my own expectations of inflation, I think long term interest rates are going to turn out to be high in real terms, but that is not an operational target for the next 2 months.

Representative WYLIE. I think there will be further discussion on that. I did want to take the opportunity to get your view on it.

I think what we are all trying to achieve is the same goal, although we may have different opinions on how we might get there.

Thank you very much, Mr. Chairman.

Representative REUSS. Thank you, Congressman Wylie.

DESIRABILITY OF SHIFTING TIMING OF FISCAL STIMULUS RESTRAINT

I have just one question for you, before proceeding to Congressman Kemp. I agree completely with your outlook on the proposal to accelerate the July 1, 1983, 10-percent tax cut, as set forth in your answers to Representative Wylie and Senator Proxmire.

Your view is that just to do that would increase the current year's budget deficit from its already outrageous dimensions by another $13 or $14 billion. The second part of your view is if, however, such an acceleration were accompanied by locked-in measures to reduce the budget deficit in the out years, you might view the whole thing favorably. Then you would be getting the stimulation where admittedly a stimulus is needed right now, but you would be reducing the stimulus from fiscal 1984, fiscal 1985, and succeeding years.

Mr. **Volcker**. And therefore, I think, having a different impact on interest rates and the problems of monetary policy.

Representative **Reuss**. Exactly. I agree entirely with what you said. I would ask this question: I have suggested that a possible way of doing that would be to accelerate the July tax cut but to cap it to provide in effect that it would go to people making less than $50,000 a year. People making more would, of course, get at least $700. But it would taper off at about that level. That would markedly decrease the current deficit by several billion over what President Reagan is musing about, and in the out years, next year and 1985, it would reduce the deficit now contemplated by $7, $8, or $9 billion a year. The net deficit reduction would continue.

Again, without asking you to give your views of that particular approach, is not the arithmetic of that appealing?

Mr. **Volcker**. I have not looked at the arithmetic. If the arithmetic shows trading a reduction now for an insured improvement later, I think that goes in the right direction.

I am clearly not commenting on your particular proposal, which I think has other aspects that would be inappropriate in my opinion.

Representative **Reuss**. Your answer to Senator Proxmire about the rate in growth of military, you were not prepared to suggest weapons systems, et cetera.

Mr. **Volcker**. Exactly.

Representative **Reuss**. Congressman Kemp.

Representative **Kemp**. Thank you, Mr. Chairman.

I, too, want to join my colleagues, Henry, in thanks to you, in your last hearing. We all wish you well. You have been a friend, highly respected on both sides of the aisle. I appreciate my colleague, Representative Wylie, alluding to that fact earlier.

Welcome, Chairman Volcker. It is a tremendous opportunity to sit in on these hearings. There is tremendous interest in monetary policy. Bill Proxmire has the ability to cut through many of the problems, and get right to the heart of the matter, and that is the concern that we all have over the economy and the role that monetary policy plays in the economy.

There is tremendous interest in your testimony today. It could be said that you are outdrawing the NFL at this moment, Mr. Volcker. All of the markets are watching what you and we do.

To that end, I think it is important that I not be tempted to get into fiscal policy. I think the issue is monetary policy. That is why I really wanted to be here today. So I will resist the temptation to defend the third year of the tax cut and defined moving it up and defend my arguments against trying to redistribute income through a more steeply graduated income tax.

Much of your testimony, many of your remarks, many of your answers to Chairman Reuss, Senator Proxmire, and Representative Wylie, have been articulate in enunciating the problems you have in narrowly targeting either interest rates or a quantity of money.

You mentioned the All Savers Certificates coming due, which has caused technical aberrations in the supply targets. You have mentioned problems in other areas. I think if you look at those charts there on the wall you will find that the definition of money changed between 1981 and 1982. You make the statement, and then you allude to it again later on, that in setting targets, as a practical matter, attempts to target and fix interest rates would make a more rigid monetary policy, politicize the process. I think from your statement it can equally be said that narrowly targeting a definition of money and holding to it, irrespective of what happens to the economy and interest rates and exchange rates, would also be rigid and political. Part of the frustration, Mr. Volcker, part of the reason for introducing bills like H.R. 7218, is not to politicize the Fed, not to make you less independent, not to go back to a preset 1979 interest rate target, but to come to a balance so that we can, as Bill Proxmire pointed out, achieve economic growth.

And if we do not achieve economic growth, if we don't get the Nation back to high levels of output and production, there is going to be, I'm afraid, not just a sense of frustration in the Congress, but overt attempts to reduce the independence of the Fed.

I am pleased by your testimony, at least that part in which you have suggested that for technical and nontechnical reasons, you have moved away from that experiment in monetarism for 3 years or so, or narrowly trying to define money and control its quantity.

My concern is for the future. Much of your testimony has been looking backward, and my concern is about the future.

You have mentioned the problems you have had with targeting interest rates. Again, to mention H.R. 7218, we are not interested in exclusively targeting interest rates. I do not even think Chairman Reuss, if I heard him correctly, has suggested that you can narrowly target interest rates. It is true, however, Mr. Volcker, is it not, that the Federal Open Market Committee, on a month-to-month basis, over different periods of the year, does target the Federal funds rate, which is an interest rate?

Mr. **Volcker**. I would not interpret what we are doing now as setting targets for the Federal funds rate. We used to do that prior to 1979, as a means of reaching the monetary target. It turned out not to be a very good means, in my judgment, but that is what we used to do.

We do not target it now. We do, in our directives, set down a rather wide band for the Federal funds rate, which is as a signal; if it reached the outer ends of those bands, we would want to review the situation. We have done that on a number of occasions, usually when it has hit the outer ends of those bounds.

It goes through—the directive does not say, "Hold it there." It says, "Consult if that happens." I do not determine that as a target.

Representative **Kemp**. Thank you, Mr. Volcker. As I have tried to suggest in the past, interest rates, exchange rates, even, indeed, the quantity of money or other aggregates, are not directly targets, as much as they are tools of policy. Why use a quantity target when the goal is price stability? Why not use prices themselves?

In other words, why not find some price that you think could be used as a proxy for the price level? I'm not saying what it should be, but you can find in history that there are proxies for the general price level, and what we are seeking is price stability, a stable unit of account, and honest money.

Why couldn't we abandon money quantity, abandon interest rates, or at least use them only as tools, and target the one thing that the

American people want us to look at, and that is maintaining the purchasing power of the dollar?

Mr. VOLCKER. I fully agree with you as to what the purpose is in the end: We want a stable currency, a sound currency, stable purchasing power of the dollar along with a growing economy.

The question is how you best get there, which brings up operational questions, tactical questions. There is no disagreement on the goal. The reason that we use these quantities has a long history. It has a long history of congressional interest in these monetary targets of increasing interest over the 1970's which was finally incorporated into law in the Humphrey-Hawkins Act. That history is based upon two notions: One, that over periods of time there is a relationship between these quantities in a lot of different economic circumstances and what we are ultimately interested in, the price level, which corresponds with lags of unknown duration; and two, we cannot directly control money, but we can strongly influence it, at least one removed, through changes in bank reserves.

We have not got a similar instrument to work directly on prices. We have got a whole lot of price indices which we will affect in the end. But how do we link up what we do today with the broadest price indices that we are interested in, and whose stability we are interested in? It is a period of, unfortunately several years, before you get the results.

So we are looking for an intermediate stage that goes toward the objective that you and I share.

Representative KEMP. I am glad to hear that, I think. And I would like to explore it a bit more.

COMMODITY PRICE TARGETS

I am not talking about sluggish measures like the CPI or the WPI, the wholesale price index. But let's go back to 1979, Mr. Volcker, and look at commodity prices. Take the Commodity Research Bureau, the Bureau of Labor Statistics, the Dow-Jones Commodity Price Index, and you will see tremendous rise in commodity price index measured on any one of a number of commodity indices in 1979. It peaked in 1980 and has dropped from 1980 to 1982 at an incredible rate. Commodity prices are significantly under the level that they were at in 1980 and 1981.

My question is: Would you be concerned for the future if commodity prices continued to fall? If the price of gold goes much under $400—I understand it is about $404—what would be the reaction? Would you then inject reserves to expand the supply of money?

Mr. VOLCKER. Yes.

Representative KEMP. So you need some other target because of the problem that you have mentioned with regard to the demand for money. Doesn't the price level, as measured, say, without trying to exactly define it, by commodity prices, doesn't that take into account both the supply of money and the demand for money? Doesn't that solve a little bit of your problem?

Mr. VOLCKER. Commodity prices certainly give you information. The way commodity prices were behaving in 1979 and early 1980 was certainly an indication to me of inflationary pressures and inflationary expectations. They were certainly a factor in my mind, anyway, in policy formations.

I think you can say the same thing about the subsequent rise in late 1980 and 1981. Certainly, I take the rather long period of decline, now, since early 1981 and really continuing into the present, as an indication that there is this inflationary pressure on the economy, and we take that into account.

In that general sense, commodity prices are relevant, yes. That is quite a long way—a tremendous distance—from saying, as I have heard some people say, "Why not use commodity prices as a kind of day-by-day indication of whether you should add or subtract reserves?"

The trouble with that is that this is a very highly volatile series over time, and you expect fluctuations in commodity prices. I would guess—more than guess—that some commodity prices are, certainly in a sense, too low, relative to the average price levels. It is not very profitable, for instance, to mine copper, at the moment. If prices just leveled out today at general price levels, presumably at some point the copper price would have to rise to go back into equilibrium.

Representative **Kemp.** I understand the problem with copper.

Mr. **Volcker.** I think you can say that about the whole commodity price index at the moment, because it is affected by the fact that we are in a recession. I don't think that we can assume, let's say, the commodity prices are in equilibrium today and therefore should be stabilized from this day on.

Representative **Kemp.** I made that point myself. Commodity prices are somewhat lower.

My question really, Mr. Volcker, is, What are you going to do? What rule? The reason that Chairman Reuss, Senator Proxmire, Representative Wylie, and all of us are desperately looking to you is because we want to know what you are going to do in 1983? It is not enough to go back to M_1 or even M_2.

My wife has money market funds. She thinks they are a savings. I have got a sweep account. I don't think you can tell the difference between which is money and which is savings.

Mr. **Volcker.** I can't.

Representative **Kemp.** My question is, What are you going to do in 1983?

Mr. **Volcker.** You are asking me a question in the same way Senator Proxmire asked me a question: Won't you please give us a simple rule that you will follow?

I am afraid I am in the position of telling you I am suspicious of any rule that is that simple. It would be very nice to say: "We could just follow commodity prices, or target interest rates." I don't think life is quite that simple. These relationships change.

What we do say is that among all of these relatively simple rules there is a big body of history behind the monetary quantity. Currently, it is getting distorted by all of these institutional changes; we have to be very cautious about it. What I am saying in a good part of my statement, as you accurately note, is that there is a lot of doctrine, history, experience, behind that rule. Beware of making it too simple; beware of making it too simple in these disturbed periods.

So then you say: "Give me another rule." I would like to give you another rule that is very mechanical, that will tell you that we will stabilize commodity prices between x and y, or the Dow Jones index, or the gold price. But any of those rules would suffer from oversimplicity, more so than the quantitative rules.

So I have said, "I suppose if we have a rule of that sort, you could replace the Federal Reserve with a computer." I don't think we are going to reach that stage very soon.

We have to apply some judgment using the very points that you mentioned, they are very relevant to me, but they do not provide a simple operating rule.

Representative **Kemp**. I have been a critic of monetary policy in the past. I want to say in recent history, that is at least since July and June, and even to look at an earlier date, I have been applauding what you have been doing. I think there has been a significantly broader approach to the conduct of monetary policy.

What I was suggesting a little bit earlier is that it seems to most Fed watchers there has been a shift away from a fix on just the quantity of money, and that is applauded by many of us.

I am also suggesting that just fixing interest rate targets is not possible. We have introduced a modest Monetary Policy and Price Stability Act, just to vent a little of our frustration, which is assuaged somewhat, Mr. Volcker, by your approach recently, to monetary policy.

My real questions are about the future. I am not asking for a simple target. I am not asking for simplicity, or taking away your independence, or turning you into a computer. But the American people—at least the people I represent—are interested in several things. They want stable money, stable prices, they want a fixed unit of account upon which they can base contracts, so they can save once again, and provide for the future. They want a world in which Americans can trade with a sense of confidence that the unit of account will not change internationally.

The world is in economic anarchy with a very dangerous trend toward protectionism. Part of the problem is the breakdown in the confidence that that unit of account is going to be preserved, not only by the United States, but indeed the world, and the world, of course, trades in dollars, 75 percent of the world's economy, in one way or another, is denominated in U.S. dollars.

Is there some way that this country can work with our trading partners in an international sense, to get back to more stable exchange rates, get back to more confidence in the ability of nations to engage in commerce and industry without seeing those policies changed from day to day by the zero-sum, beggar-thy-neighbor approach?

Mr. **Volcker**. I hope so, and believe so. In saying that, I would think we have to get to the fundamental bedrock upon which international stability must rest in a monetary sense.

It is on the stability of the dollar itself. The dollar is extremely important, not just for us, but for the world economy. It is going to be stable. We have to have stability at home, but that does not solve all problems. As we return to that stability at home, I would hope that we would find, frankly, mechanisms and techniques for avoiding some of the extreme fluctuations in exchange rates we have had.

I continue to hope that they will damp down by themselves, given more stability in domestic currencies, and I think that is absolutely, fundamentally important. I am not at all allergic to the idea of finding other techniques to help encourage that process as well.

Representative Reuss. Any additional questions? Congressman Wylie.

Representative Wylie. Mr. Chairman, I would like to follow up on that. Ideally, we are all interested in stability. As far as inflation rates are concerned, a low inflation rate and stability as far as interest rates are concerned, lower interest rates.

WHY DID FED LOWER DISCOUNT RATE?

Last Friday—may I say that I do not want to oversimplify the discussion, or to suggest that what we are interested in—but how it impacts on unemployment. What considerations led the Fed to lower the discount rate last Friday?

Mr. Volcker. We obviously are aware of the economic environment in which that action was taken. We referred in our statement to the continued sluggishness of the economy. We referred to the fact that we do interpret these aggregates in the light of the liquidity trends that we see, and we also, importantly, refer to the fact that we think we have seen progress on inflation and that the prospect for that continuing are pretty good.

Taking all those factors into account, we certainly do not want to be an obstacle to lower interest rates. We can reduce the discount rate modestly in the climate of market rates, and we did so.

If I could add in that connection, and thinking of Senator Proxmire's earlier comments as well, I think the problem is illustrated by the Senator's comments about the need for stimulus. I think he put it very directly, considering what is going on in the economy, considering the uncertainty that is there. Congressman Kemp has emphasized, also rightly, in my view, the need for a stable currency.

The fact is, we have to be worried about both. We have got to devise some way of dealing with the situation such that we can see the economic recovery, encourage the economic recovery, without losing the gains on inflation—in fact, making more gains on inflation. If we do not do that, I fear that we will lose both goals.

Representative Wylie. You just made the point I wanted to make. Thank you very much.

Representative Reuss. Senator Proxmire.

FOREIGN LOANS BY U.S. BANKS

Senator Proxmire. What troubled me about your remarks at the 58th annual meeting of the New England council in Boston, that I was asking about, with respect to loans by American banks, internationally, and to foreign countries, was the statement you made, quote:

> It is equally a fact that given strong and necessary adjustment programs, borrowing countries will not require bank financing in amounts nearly as large as the sums provided by banks over recent years. Indeed, lending banks working effectively together with transitional needs should be able to provide the necessary margin of finance by reducing the standing loans.

It is my understanding that many of these countries are in very, very difficult financial straits. We have extended the loans, in fact. We have let them roll over, even interest that was due us. And I wonder if you have any documentation, any supporting data, that would—any study that would indicate that these countries are going to require less.

It would seem to me if you assumed the growth is going to continue, it would require more.

Mr. VOLCKER. No, I can provide you data in that connection, for the record, Senator. I will not remember all the data off the top of my head, but take the Mexican case. Mexico, if I recall correctly, in 1981, borrowed net abroad around $20 billion, something like $14 billion from banks. The adjustment program that they have entered into with the IMF looks toward a current account deficit of one-half or one-third of what they had in 1981. I do not remember the exact comparison with this year, which is not completed. It implies little or no growth in Mexico for a year or two, explicitly, and it will require an amount of financing that will be only a fraction of what was required in 1981 and a considerable reduction from what was required this year. I can provide you the numbers.

Senator PROXMIRE. If you would do that in other areas, too, not only Central America, but South America, Asia, and so forth.

[The information referred to follows:]

FEDERAL RESERVE SYSTEM,
Washington, D.C., November 30, 1982.

Hon. WILLIAM PROXMIRE,
U.S. Senate,
Washington, D.C.

DEAR SENATOR PROXMIRE: During my recent appearance before the Joint Economic Committee you asked me to explain in greater detail how international banks could continue to provide new credits to developing countries in the context of effective adjustment programs while at the same time reducing their exposure to those countries relative to their capital or assets. I welcome this opportunity to respond to your question about this important topic.

The enclosed table presents as background estimates of international bank claims on all non-OPEC developing countries and on certain major borrowers in this group of countries. The data in the top panel indicate that as of mid-1982 bank claims on non-OPEC developing countries amounted to about $240 billion. Claims of U.S. banks on these countries were estimated at $100 billion as of mid-1982, about 40 percent of the total for the BIS reporting area. The data in the middle panel show the increases in international bank claims in recent years and for the first six months of this year. These figures understate somewhat actual increases in claims since the end of 1980 because the strength of the dollar has reduced the dollar value of outstanding claims denominated in other currencies. The data in the bottom panel translate these dollar increases into percentages and show on average annual growth of such claims of 25 percent per year in the 1978-81 period. This rate of growth of bank claims on developing countries is not sustainable, since bank assets and capital have been growing at much slower rates.

Turning to immediate prospects, it is reasonable to expect that the capital of the lending banks will increase at a rate of about 10 percent per annum. For large U.S. banks this increase would result from an after-tax rate of return on capital of about 14 percent, a retention of about 60 percent of after-tax earnings, and an additional 1½ percent per year in increased capital raised from external sources. These assumptions appear reasonable by historical standards, particularly when banks should be paying more attention to profitability rather than to expanding their total assets. Asset growth of the major banks would probably be close to (but desirably a bit below) capital growth.

A 10 percent rate of increase in banks' capital in 1983 would be consistent with a net increase in bank claims on non-OPEC developing countries of about $25 billion with no increase in the exposure of the banks relative to their capital. The combined current account deficits of these countries may well be $30 billion smaller in 1983 than in 1981, declining from about $75 billion in 1981 to about $45 billion next year. (You will note from the table that international bank claims on these countries increased by at least $37 billion in 1981.) In this context, it is reasonable to expect that the percentage increase in bank lending required by these countries next year under their adjustment programs will be substantially reduced and should be less than the rate of growth of bank capital, thereby resulting in a small decline in exposure relative to capital for international banks in the aggregrate.

To put these figures in perspective, consider the outlook for the three major borrowers—Mexico, Brazil and Argentina—all of which are in the process of establishing strong IMF-approved adjustment programs and presumably will come within the criteria mentioned in my Boston speech that you quoted at the JEC hearing. The IMF stabilization program for Mexico assumes net new bank lending to Mexico of about $5 billion in 1983. Such lending would imply an increase in international bank claims on Mexico of about 8 percent in 1983 from the level at the end of June 1982—less than the expected increase in banks' capital next year—without making any allowance for net new lending in the second half of 1982. This outcome would be a dramatic reduction from increases of more than $10 billion per year in 1979–81. Moreover, while the quantitative implication for years beyond 1983 have not been fully developed, the IMF program plainly looks toward further reductions in the current account deficit (and implicitly in borrowing requirements) in future years.

In the case of Brazil, the Foreign Sector Program adopted on October 25 by Brazil's National Monetary Council calls for a net increase in loans from international banks of $4.2 billion in 1983, also 8 percent of outstanding claims in June 1982. By comparison these banks' claims increased more than $6 billion per year in 1980–81.

For Argentina, the IMF has projected that international banks' exposure need only increase by about $1½ billion by the end of 1983, after little apparent increase this year. Such an increase would be 6½ percent of outstanding claims in June 1982 and could represent a dramatic decline from the pace of recent annual increases, which averaged more than $5 billion in 1979–81. Again 1983 would be an "adjustment" year, implying a reduction of arrears, and would be consistent with lesser borrowings in future years.

Based on these kinds of calculations and consistent with IMF-approved adjustment programs, it is feasible to expect that an increase in the level of international bank claims to non-OPEC developing countries in general, and to the major borrowers in particular, need not, and should not, increase the exposure of banks relative to their capital base. Rather, some declines would appear more likely. In specific cases, the loans may be essential to the success of the IMF program and the net result should be to strengthen the economies of the borrowing countries.

Sincerely,

PAUL A. VOLCKER.

Enclosure.

November 30, 1982

International Bank Claims on Non-OPEC Developing Countries
(Billions of dollars)

	December					June 1/
	1977	1978	1979	1980	1981	1982
I. Outstanding Claims						
Argentina	4.8	6.7	13.1	18.9	22.9	22.9
Brazil	23.8	31.7	36.9	43.3	49.6	52.2
Mexico	19.9	23.2	30.7	41.0	55.4	61.8
Subtotal	48.5	61.6	80.7	103.2	127.9	136.9
Total	98.7	120.8	155.6	193.3	229.9	241.7
II. Increase in Amount	In 12 months to date above					In 6 months
Argentina	1.1	1.9	6.4	5.8	4.0	0
Brazil	1.7	7.9	5.2	6.4	6.3	2.6
Mexico	1.4	3.3	7.5	10.3	14.4	6.4
Subtotal	4.2	13.1	19.1	22.5	24.7	9.0
Total	11.3	22.1	34.8	37.7	36.6	11.8
III. Percentage Increase	In 12 months to date above					In 6 months
Argentina	32	40	96	44	23	0
Brazil	8	33	16	17	15	5
Mexico	8	17	32	34	35	12
Subtotal	12	27	31	28	24	7
Total	14	22	29	24	19	5

1/International bank claims normally increase relatively slowly in the first half of the year.

Source: Bank for International Settlements.

Mr. VOLCKER. I am not saying that is true of every country in the world. It is true of these major borrowers that have been very large users of bank credit in recent years.

Brazil has announced an external adjustment program that would cut their balance-of-payments deficit about in half, as I recall it, in 1983, from this year and last year.

Senator PROXMIRE. Can you tell me, would there be a global net increase in U.S. dollar loans needed in 1983 and 1984?

Mr. VOLCKER. I have not looked at it in those terms, but my presumption would be yes, in 1983, consistent with all of these adjustment programs there would be a net increase, but a much smaller increase.

Senator PROXMIRE. There will be an increase.

Mr. VOLCKER. I have not looked at countries closely, for example, in the Far East, where you have some growing, strong countries that have done external financing. I just do not recall offhand how that trend would look compared to last year. Certainly if one looks at Latin America or Eastern Europe it would be comparable.

Senator PROXMIRE. The U.S. trade deficit is a drag on the economy already, and is likely to get worse before it gets better. As the U.S. economy begins to recover, imports are likely to rise, the dollar exchange rate is likely to decline. New York Federal Reserve estimates that the U.S. current deficit can be widened by $45 billion—that is 1½ percent of the gross national product—by the end of next year.

Do you agree with the New York Fed's estimate of what are the implications of the U.S. economic recovery?

Mr. VOLCKER. I have not looked at that in detail. I am aware that most estimates, looking ahead at our trade or current accounts balance, would show a sharp deterioration. I think as things look now I certainly agree that that trend will be toward a widening of the current account deficit.

We have had a relatively strong current account position for several years.

Senator PROXMIRE. That's right, and that is one of the things that I think has been encouraging about the economic performance. If it were worsened that dramatically, by $45 billion, it seems to me that could have a severe effect on our economic recovery.

Mr. VOLCKER. It is moving in the direction of worsening. I think, importantly worsening. It is a reflection, in part, of the very steep climb in the exchange rate in the past year or so.

To the extent that climb doesn't continue, that may moderate the trend, but the trend is in the direction of worsening.

Let me say, while I have the chance, because it is relevant to both of your questions, that there are pressures for protectionism in the world, and that affects the prospect for our trade balance. It also affects the possibilities and the probabilities of these borrowing countries in the midst of big adjustment programs turning their situation around in the healthiest way, which is by approving their trade and current account positions.

It seems to me—and I understand the pressures, we all do—but I just want to record my own view that these financial problems are tied with trade problems and include the temptation of moving toward protectionism, of not moving ahead in negotiations that are going on now toward maintaining the elements of liberal trade. That will complicate all of the financial problems, complicate the borrowing problems, that you are worried about.

Senator **Proxmire.** As you know, there is a strong tendency to move in that direction now, and I am quite sympathetic with it, as are others. But if our current account deficit worsens to $45 billion, the pressure is going to be very hard to resist.

JOBS/GAS TAX PROGRAM

Let me ask you, what is your view on the $5 billion program of highway and bridge repair to put the unemployed to work—and first, with the 5-percent increase in the gasoline tax——

Mr. **Volcker.** If there is a need for that infrastructure work, and I assume there may well be, I think it has got to be paid for, given our budgetary situation. The increase in the gasoline tax to balance those needed expenditures seems to me quite reasonable.

Senator **Proxmire.** Do you share the view, or have any opinion on the view, of Chairman Feldstein, that this would probably, in his judgment, decrease the number of jobs net, because of taking the money out of other sectors of the economy?

Mr. **Volcker.** We had a little discussion about that recently. One of his concerns, which I understand, is that the way we do these indexes—and I am not sure this makes a lot of sense, conceptually—if you rely on an excise tax instead of an income tax, let's say, it will show up in the price index; and if you aim toward the same price level, along the lines of Representative Kemp's thinking, there is a little less money to go around for other things, because of the impact on the price level.

I think that is probably small enough so it does not strike me as a major element of consideration. I think essentially the program would be balanced if the taxes balance the expenditures.

In terms of its effects, its employment impacts, I think it should be viewed as a program to improve the highway system, the mass transit, or whatever.

Representative **Reuss.** Thank you. Congressman Kemp.

Representative **Kemp.** Let me once again thank you, Chairman Reuss, for your allowing me to sit in today. Also, to Senator Jepsen, with whom I talked, and I appreciate his hospitality as well.

I know it is getting on in the day, Mr. Chairman. Mr. Volcker, I too share your belief, and I think many people's goal, of a liberal trade policy. I think part of the problem in supporting liberal trade policies in the Congress and in the world is due to the change in currencies that has been a result of this floating paper standard experiment since the breakdown of Bretton Woods in 1971. But really, my question has to do with your statement, where you say you are required by law to give us the targeted aggregates, in the relevant money and credit area. Would it help, Mr. Volcker, if the law were changed?

Is there something we can do in Congress to help you provide a more balanced approach? Are you encouraged by the rally in bonds and stocks since you have moved, even temporarily, away from the aggregates? Can we do anything to encourage that? What changes in law could be made to help you move toward a balanced monetary policy, price stability—all the goals that we have for this Nation?

Mr. VOLCKER. I don't want to provoke any disagreement, but I think I had better put a footnote on your comments. You refer to moving away from the aggregates. I would express it as maintaining concern about the aggregates, but using common sense in interpreting them.

I certainly am encouraged, particularly by the long-term rates, because I think that must have an element of more conviction about the price outlook; I am even more encouraged about that than the decline in short-term rates, which I also would like to see.

I am not at all unhappy, obviously, about seeing higher stock prices. I might comment that the volatility of those markets concerns me. I would like to see high stock prices and low interest rates, because I think that is in accordance with what I see as the outlook.

I do not like to see the degree of volatility from day to day that exists in those markets, because I think it is still a reflection of uncertainty and unsettlement, and I look forward to the day when we see low interest rates and high stock prices, but in a framework of greater stability.

Now, you specifically asked, very kindly, what you could do to help us. I do not think I would suggest any changes in the law at this point. I would, in effect, plead—if that is a proper interpretation of my statement—for the need for judgment in interpreting these things, and taking account of some of the very variable that you have mentioned this morning.

Representative KEMP. Again, I am encouraged by that.

But it seems to me what you are telling us is that we are not going to have much of a standard at all. We are going to have a Paul Volcker standard, and I do not mean that to be acrimonious. But the Congress must know, the markets must know, the philosophy around which the central bank is going to conduct monetary policy here and abroad. I remember somebody saying if we even abandoned M_1, inflationary expectations would rise, bond prices would fall, and all sorts of malevolent things would occur.

Well, we moved away in June, from a slavish devotion to M_1. In July and August we moved further away from M_1. We are told here today that you, for technical reasons and other reasons, want to look at a broader array of targets. There has been a rally. Stocks and bonds and interest rates have all been more optimistic, more positive, more bullish, if you would.

And my question simply goes back to something that I probably asked before, but nonetheless I want to reiterate it. It seems to me that the success that you have had in moving away from the aggregates should not be revised—we should not go back to that mistake.

We should have learned by the mistakes over the past 2 or 3 years. I guess what I want you to do is to tell me, can't Congress help codify those changes? Can't we help institutionalize those changes? Can't we tell the world that from now on we will be more interested in stable prices, an honest unit of account, a world in which we can have liberal trade around a more stable exchange rate, rather than this standard of how you or the Open Market Committee wakes up in the morning?

Mr. **Volcker.** Apart from any interpretation of exactly what we have been doing recently, I have repeatedly emphasized the importance I attach to these aggregates as kind of a discipline, properly interpreted. You cannot interpret them in too simple-minded a fashion; I refer to the problem of any rigid, very simple rule.

You raise, again, the question of what Congress can do. Let me say it is an old debate, it is an old question, but in connection with the philosophical approach that you have mentioned; and I agree: the world has got to know what our philosophy is toward the basic objectives of our policy.

We have talked about price stability. That could appear in the law more clearly than, in fact, it does, I think. It is not clear in the Federal Reserve Act, the original act, where it was not mentioned. The question is sometimes raised about the priority that goal has.

I was talking about legislative changes in the broadest sense, which I think is the sense you might be raising them. It might be worth looking at that point.

Representaive **Kemp.** You and I had lunch a couple of months ago, and you said that you cannot control the demand for money. So the aggregate is not a target. It is only a tool. So we agree on that.

My sense is that one good that may come out of this meeting is that if M1 or M2 were rising, it is important to know whether a demand for money and liquidity is causing the rise or whether it's due to your having expanded reserves, by buying government securities. It seems to me the only way you can tell whether it is inflationary or consistent with price stability is to have some measure—not now knowing what that should be.

I happen to prefer commodity prices, or gold as a proxy, or what Zelle Fiilstra suggested as a band for the price of gold around which you would operate. Unless you use another tool for monetary policy, how can you measure whether the "M's" are going up or down, according to the demand or the supply, without looking at prices?

Mr. **Volcker.** I don't think we can. Let me just complicate the question a little more. You're quite right, one of the variables you want to look at is whether this is being influenced by a change in demand or a change in supply. You can look to a variety of things to help interpret that. You can look, among other things, at interest rates; that gives you a clue. Prices certainly give you a clue. The direction of the economy gives you a clue.

I complicate the question even further, because in present circumstances we also have to consider to what extent entirely extraneous changes in institutions from regulations are causing it. We have got to take that into account, too.

My only difference—it may not be a difference—is that I think that we have to look at a variety of things to make that judgment, certainly including prices. We have to keep very much in mind—and this comes back to the whole philosophy, I suppose, of targeting these aggregates—is that what might be chosen today, what we might accurately judge today—maybe inaccurately—may be inappropriate tomorrow, if a change in the demand for money quickly reverses itself. We do not want to do things today that aggravate the problem tomorrow, to the extent we can help it.

There is some presumption, in history, if you will, as was mentioned earlier, that changes in velocity, to use that particular measure, will reverse themselves.

I have already indicated that I am not sure that everything we are seeing now, in terms of the extent and length of change in the velocity, implies that that is going to be fully reversed.

Representative KEMP. I could not agree more, except it seems to me, if I were part of the process of the central bank, and prices were falling and interest rates were falling and the price of gold was falling, and velocity were down, that that would be a signal of some sort, and that you could measure when to expand or withdraw reserves in the system around some designated target that is better than M_1 or M_2.

M_2 rose at a 13.1 percent rate in 1976–77. The growth went down to 8.5 percent in 1978–80, while inflation was going up. That is unbelievable. When I started looking at this, I came to the conclusion that there was no use in targeting M_2, because M_2 was slowing in 1978 and 1979, when the dollar was collapsing, and people in Europe were mad at us for allowing the dollar to be too soft, and something had to be done. M_2 has dropped from a 13.1 percent increase in 1976–77 down to 8.5 percent by 1980.

Now, clearly, as you point out, the demand for liquidity, money and cash and money market or instruments was changing.

I appreciate this opportunity, Chairman Reuss. You have been very kind.

And Mr. Volcker, again, this debate is not over. I appreciate the contribution you are making.

1951 ACCORD RECALLED

Representative REUSS. Both Senator Proxmire and Representative Wylie in the last couple of minutes have whispered to me that they think this is the most instructive hearing held in many years between the Joint Economic Committee and the Federal Reserve, and I heartily agree. I congratulate you and remind myself that it was about 31 years ago that the Joint Economic Committee helped rescue the Federal Reserve and enabled the Fed to be in a position to do a job on maximum employment, production, and purchasing power.

And I end up here today with the hope that it will continue with the Open Market Committee and perhaps of this discussion here today and out of that colloquy with your colleagues can emerge a new accord which will get Congress, the Federal Reserve, and the country going in the same direction: toward full employment. Thank you very much for your testimony.

Mr. VOLCKER. Thank you, Mr. Chairman.

Representative REUSS. The committee stands adjourned.

[Whereupon, at 12:20 p.m., the committee adjourned, subject to the call of the Chair.]

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